ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

CHALLENGES FACING ISLAMIC BANKING

MUNAWAR IQBAL
AUSAF AHMAD
TARIQULLAH KHAN

Occasional Paper – No. 1

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FOREWORD

Islamic banking practice, which started in early 1970s on a modest scale, has shown tremendous progress during the last 25 years. Serious research work of the past two and a half decades has established that Islamic banking is a viable and efficient way of financial intermediation. A number of Islamic banks have been established during this period under heterogeneous, social and economic milieu. Recently, many conventional banks, including some major multinational Western banks, have also started using Islamic banking techniques. All this is encouraging. However, the Islamic banking system, like any other system, has to be seen as an evolving reality. This experience needs to be evaluated objectively and the problems ought to be carefully identified and addressed to.

It is with this objective that the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) presents this paper on *Challenges Facing Islamic Banking*, as decided by the IDB Board of Executive Directors. A team of IRTI researchers consisting of Munawar Iqbal, Ausaf Ahmad and Tariqullah Khan has prepared the paper. Munawar Iqbal, Chief of the Islamic Banking and Finance Division acted as the project leader. Two external scholars have also refereed the study. IRTI is grateful for the contribution of these referees. The final product is being issued as the Second Occasional Paper.

It is hoped that serious consideration will be given to the challenges facing Islamic banking identified in the paper. Theoreticians and practitioners in the field of Islamic banking and finance need to find ways and means to meet those challenges so that Islamic banking can keep on progressing as it enters the 21st Century.

Mabid Ali Al Jarhi
Director IRTI

SECTION 1
SCOPE AND METHODOLOGY

This paper aims at taking stock of the developments in Islamic banking over the past two decades and to identify the challenges facing Islamic banking to remain viable, to meet the growing competition and to develop and prosper. The practice of Islamic banking as it developed during our times has four main manifestations:

a. Banks in those countries where efforts are being made to restructure the entire banking system along the Islamic lines. These include Pakistan, Iran and Sudan.
b. Islamic banks in the private corporate sector.
c. Islamic Financial Institutions other than banks in some Muslim as well as non-Muslim countries and
d. Islamic banking practices undertaken by some conventional commercial banks and non-bank financial institutions.

This study focuses on the problems and challenges facing Islamic banking in the private corporate sector in a mixed environment. That comprises the bulk of Islamic banking. An attempt has, however, been made to make some observations, wherever possible, regarding institutions working in other environments.

The methodology used for this research is both analytical and empirical in nature. For the analytical part, the existing literature was thoroughly surveyed. A comprehensive list of issues relevant for the future of Islamic banking was prepared. A questionnaire based on these issues was

mailed to 100 scholars, bankers and *shari'ah* experts all over the world. Out of these, 60 filled and returned the questionnaire. The perception of these experts on various problems facing Islamic banking is summarized in Annexure-I. The results of the questionnaire have not been fully analyzed yet. However, the authors benefited from these responses in formulating the major challenges facing Islamic banking which have been discussed in the paper.

For the empirical part, an attempt was made to collect statistical data relating to the main activities of Islamic banks and analyze it using various statistical techniques. However, this effort was severely constrained by the quantity and quality of available data. Details about the sources and quality of data are described in Annexure-II. Every attempt has been made to collect data from all possible sources and reconcile it so that it could become consistent as far as possible. Since the quantity of data was also limited, an attempt was made to get the maximum mileage out of the available information. In some cases, the study is confined only to a "snapshot" of the latest position, in other cases, it attempts to provide comparative statics. All this is due to non-availability of a consistent and sufficiently long time series which is necessary to carry out any in depth evaluation of Islamic banking during the last two decades. Where generalizations on broad features were to be made, the technique of pooling time series and cross-section data has been used because this technique minimizes the impact of inter-bank and inter-temporal variations. It is believed that these efforts would enable us to draw some statistically meaningful results, at least in general terms, if not with exact magnitudes.

SECTION 2
TAKING STOCK

Islamic banking, like any other banking system, must be viewed as an evolving system. No one disputes that there is a definite desire amongst Muslim savers to invest their savings in ways that are permitted by the Islamic *shari'ah*. Nevertheless, they must be provided with *halal* returns on their investments. Islamic scholars and practical bankers took up that challenge and have made commendable progress in the last twenty-five years in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.

Islamic banking and financial institutions now spread in several Muslim countries. Some non-Muslim countries and/or institutions are also keen to experiment with Islamic financial techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving. To design various parameters of such a system and establish supporting institutions are the biggest challenges facing the scholars and practitioners of Islamic finance in the new millennium. This study explores various aspects of the challenge facing Islamic banking in some detail. Before doing so, however, it is necessary to take stock of the existing situation.

2.1 The Rationale and Theoretical Models of Islamic Banking

In any economy, there is a need to transfer funds from savers to investors because people who save are frequently not the same people who have the ability to exploit the profitable investment opportunities. This

function is performed either by means of direct finance through securities markets or through the process of financial intermediation in the financial markets. The importance of financial intermediation can be seen by the fact that around two third of new investment passes through this process in most countries.

Financial intermediation enhances the efficiency of the saving/ investment process by reducing transactions costs and eliminating the mismatches inherent in the needs of surplus and deficit units of an economy. Since the savers and investors are usually different units, they require a considerable amount of information about each other. This information is not free. Therefore, the process of channeling funds from savers to investors involves transactions costs. Moreover, due to asymmetric information, it also gives rise to the problems of adverse selection and moral hazard. Financial intermediaries can benefit from economies of scale and hence reduce transactions cost of transferring funds from surplus units to the deficit units. For the same reason, they are also in a better position to tackle the problems arising from asymmetric information.

Similarly, the process of financial intermediation removes some mismatches in the tastes, maturity terms and size of needed funds between the two sides. The surplus units are often small households who save relatively small amounts and the deficit units are the firms who often need relatively large amounts of cash. Financial intermediaries remove this size mismatch by collecting small savings and packaging these to make them suitable to the needs of the users. In addition, users of funds in general need funds for relatively long-term deployment, which cannot be met by individual suppliers of funds. This creates the mismatch between the maturity and liquidity preferences of individual savers and users of funds. The intermediaries resolve the conflict again by pooling small funds. Moreover, the risk preferences of small suppliers and large users of funds are also different. It is often considered that small savers are risk averse and prefer safer placements whereas the fund users deploy the funds in risky projects. Therefore, the funds cannot be directly supplied. The role of the intermediary again becomes crucial. They can substantially reduce this risk through portfolio diversification. Furthermore, small savers cannot efficiently gather information about investment opportunities. Financial

intermediaries are in a much better position to collect such information, which is crucial for making the investment successful.

The role and functions of banks outlined above are indeed highly useful and socially desirable, but unfortunately, interest plays a central role in each of these functions. Islamic financial intermediation endeavors to replace interest by other modes and instruments both for mobilizing savings and for putting those savings to productive use. The functions that the banks perform are important whether the economy concerned is secular or Islamic. People **need** banking services. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This challenge provides the rationale of Islamic banking.

Financial intermediation maintains a pivotal role in Islamic banking and finance. Historically, the role of a financial intermediary in the Islamic economy is found in the principle of *al mudarib udarib*; a practice which has existed in Islamic history since early centuries. It can be expressed as, *"the one who mobilizes funds, on profit-sharing basis, extends these funds to the users on the same basis"*. Similarly, in leasing, the lessee who possesses the usufruct, may sell these against a higher price (rent), and create additional value. In the early Islamic period, most caravan trades were financed by *mudarabah* (trust financing). In trading, it is possible to purchase something on order at a given price and resell it to the orderer of purchase at a higher price. Islamic scholars consider the earning of profits from an intermediary role as a genuine occupation. It is however, noticeable that this concept of financial intermediation is interwoven with the production and exchange of real goods and services.

The functions of Islamic banks and other financial intermediaries are similar to their conventional counter-parts. Theoretical studies have used alternative Islamic modes of finance to build models through which those functions can be performed. Some studies have shown that Islamic models can perform those functions in a better way. Some of those models are briefly described below.

2.1.1 Two Tier Mudarabah

The main feature of this model is that it replaces interest by profit sharing on both the liabilities and the assets sides of the bank. The main business of the bank is to obtain funds from the public on the basis of *mudarabah* and to supply funds to businessmen on the same basis.

The bank can have general (unrestricted) investment deposits or restricted investment accounts in which deposits are made for investments in particular projects. It is also possible to conceive of restricted investment accounts in which deposits are made on the condition that they be invested in particular business activities. Then, there could be current accounts in which deposits are made to be withdrawn at any time. These are checking accounts on which banks pay no profit but they are allowed to use these deposits profitably at their own risk. Demand deposits are in the nature of loans to banks whose repayment is guaranteed. In sum, bank funds could comprise share capital, demand deposits, and various types of investment deposits.

A number of positive effects for the efficiency, equity and stability of the banking system are expected from the application of this model. These will be discussed later in the paper.

2.1.2 One Tier Mudarabah Combined with Multiple Investment Tools

Early works on Islamic banking were based on the traditional forms of Islamic modes of finance such as *mudarabah* and *musharakah*. However, in practice Islamic banks faced a number of difficulties in using these modes to a significant extent. Subsequent writings and practices of Islamic banking have made important contributions to the evolution of new forms of Islamic business enterprises as well as to the conceptual development of Islamic financial modes and instruments. Substantial developments also took place in developing new variants of the traditional modes of finance. The traditional modes of finance were based on either partnerships or the principle of deferred trading of goods and services. The practice of Islamic financial institutions has led to the evolution of different types of permanent, temporary as well as declining partnerships based on the principles of *musharakah* and *mudarabah,* with easily adaptable

arrangements with respect to managerial responsibilities. Islamic banks have also developed various forms of price and object deferred sales; such as short-term *murabahah* (declared cost-plus-profit based financing), installment sale (long and medium term *murabahah*); pre-paid or price-deferred manufacturing orders (*istisna'*) and pre-paid or rent-deferred leasing (*ijara*).

These developments have led to the emergence of a different model of Islamic banking. Under this model, the relationship between savers and the bank is organized on the basis of *mudarabah*. However, in its relationship with the entrepreneurs, the bank uses a number of other modes of finance permissible from *shari'ah* point of view, none of which involves interest. The principal among these are: *mudarabah*, *musharakah murabahah*, *ijara*, *salam*, *istisna* and loans on the basis of a service charge (i.e. recovering only the actual administrative expenses incurred on mobilizing funds). By varying different payment and delivery options within each of these modes, a variety of Islamic financial instruments have been developed.

2.1.3 Islamic Bank Working as an Agent (Wakeel)

It is also possible that Islamic banking is arranged on a basis of agency principle. An Islamic bank will manage funds on behalf of its clients on the basis of a fixed commission. The terms and conditions of the *wakalah* contract are to be determined by mutual agreement between the bank and the clients.

2.2 Distinguishing Features of Islamic Banking

While Islamic banks perform mostly the same functions as the conventional banks, they have their distinguishing features. Some of these are given below:

2.2.1 Risk Sharing

The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) on the one hand and both the financial intermediary (the bank) and the user of funds

(entrepreneur) on the other hand. By contrast, under conventional banking, the investor is assured of a predetermined rate of interest. Since the nature of this world is uncertain, the results of any project are not known with certainty ex-ante. Therefore, there is always some risk involved. In conventional banking, all this risk is borne in principle by the entrepreneur. Whether the project succeeds and produces a profit or fails and results in a loss, the owner of capital gets away with a predetermined return[1]. In Islam, this kind of unjust distribution is not acceptable and hence in Islamic banking both the investor and the entrepreneur shares the results of the project in a way that depends on the supply and demand for funds. In case of profit, both share it in a pre-agreed proportion. In case of loss, all financial loss is borne by the investor and the entrepreneur loses his labour.[2]

2.2.2 Emphasis on Productivity as Compared to Credit Worthiness

Under conventional banking, all that matters to a bank is that its loan and the interest thereupon are paid to it on time. Therefore, in granting loans, the dominant consideration is the credit-worthiness of the borrower. Under Profit-Loss Sharing (PLS), the bank will receive a return only if the project succeeds and produces a profit. Therefore, an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur. This feature has important implications for the distribution of credit as well as the stability of the system. Some of these implications will be mentioned later in this paper.

Even under non-sharing modes such as *murabahah*, the financing is linked to a commodity or an asset. This ensures the involvement of finance in the productive process and minimizes speculative or wasteful use of funds.

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[1] However, the owner of capital is exposed to the "intermediation risk" which results from the bank extending too many non-performing loans, leading to inability to repay fund providers.

[2] Some Islamic banks bear voluntarily part of the loss through reducing their profit share in order to keep their customers.

2.2.3 Moral Dimension

Conventional banks generally pay little attention to the moral implications of the activities they finance. As against this, in the Islamic system all economic agents have to work within the moral value system of Islam. Islamic banks are no exception. As such, they cannot finance any project which conflicts with the moral value system of Islam. For example, they will not finance a wine factory, a casino, a nightclub or any other activity which is prohibited by Islam or is **known** to be harmful for the society.

2.3 Islamic Banking in Practice

Islamic banking began on a modest scale in the early sixties. Most of the early attempts in Islamic banking took place on individual initiative with governments playing no or at best a passive role. The later growth of the Islamic banking movement has been helped by the encouragement provided by the governments of some Muslim countries. The establishment of Islamic banks in a number of countries has been effected by special enactments and changes in banking legislation. It should be mentioned that those changes were not intended to confer any undue advantages on those banks vis-à-vis conventional banks. They were in fact designed to remove some of the obstacles that hindered the establishment of Islamic financial institutions.

Two different approaches are discernible in regard to Islamic banking practices. In many countries, where the governments have not committed themselves to the abolition of interest, Islamic banks exist side by side with interest based banks. Pakistan and Iran are following a different approach aimed at economy wide elimination of interest. In Sudan, where Islamic banks co-existed with interest based banks for a long time, the government later opted for economy-wide Islamisation of banking. In Malaysia, a mixed system is being promoted at an official level. Islamic banking windows are being encouraged in conventional banks in addition to some Islamic financial institutions as such. The monetary authorities recognize and regulate both conventional and Islamic banking. The focus of this study, as mentioned before, is Islamic banks working in the private corporate sector in a mixed environment. Therefore, we will now review their past performance.

Islamic banks have succeeded in mobilizing large amount of funds. In 1980s, the deposits in almost all Islamic banks were growing at a rapid pace.[3] Many studies testify to the highly successful deposit mobilization by Islamic banks. According to one study,[4] the data relating to the period 1980-1986 showed that the relative growth of Islamic banks was better in most cases than the growth of other banks. That resulted in increasing the shares of Islamic banks in total deposits. Another study observes as follows: "These early institutions have now matured, and have achieved a considerable degree of success in terms of market penetration. This is all the more remarkable given that the markets in which they were established already had well developed commercial banks; indeed, some markets, especially in the Gulf, were viewed as over-banked". [5]

It is an unchallengable proof of the viability of Islamic banking that a number of conventional banks are also entering into this market. A Western observer of Islamic banking has very aptly remarked that "it is an excellent reflection on the success of Islamic banking that many conventional commercial banks are now offering their clients Islamic financial services".[6] The total amount of transactions financed through Islamic banking techniques by Islamic as well as conventional banks is fast becoming a significant amount. An estimate in the late 1993 put this figure anywhere between US dollars 25 - 30 billion.[7] Another estimate in early 1993 gave the figure to be as high as fifty billion dollars.[8] More recent estimates quote even a higher figure at sixty billion dollars that is estimated to grow at the rate of 15 percent per annum. According to an estimate by the *Financial Times*, in 1995, Islamic banking industry had 50-80 billion US dollars in deposits[9]. It is expected that total funds under Islamic banking will touch the figure of 100 billion US dollars before the turn of the century.

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[3] Ausaf Ahmad, *Development and Problems of Islamic Banks* (1987), Islamic Research and Training Institute, Jeddah.

[4] Volker Nienhaus, "The Performance of Islamic Banks: Trends and Cases" in Chibli Mallat, *Islamic Law and Finance* (1988), pp.83-122.

[5] See Rodney Wilson (ed.), *Islamic Financial Markets* (1990), p.7.

[6] Rodney Wilson, "Islamic Financial Market" in M. Fahim Khan (Ed.), *Islamic Financial Institution*, IRTI, 1995.

[7] *The Middle East Economic Digest,* Oct. 1993, p.23.

[8] *New Horizons,* January 1993, p.5.

[9] *Financial Times*, November 28, 1995.

In the long run, for its viability and survival, Islamic banking has to rely on its strength as an alternative model. The commendable achievements during the last twenty years should not lead us to ignore the problems that Islamic banking is facing, and there is no dearth of these. While many of these are a result of the difficult environment in which Islamic banks are working, there are many others which have arisen from the practices of Islamic banks themselves. In the next section of the paper, a number of these issues will be addressed. First, however, the practice of Islamic banking in the past few years with some operational details will be reviewed.

2.4 Present State of Islamic Banking and Finance

There are around ninety Islamic banking and financial institutions in the private sector, excluding those in Pakistan, Iran and Sudan where the entire banking sector is being Islamized. In 1996, these institutions managed some 28 billion US dollars. The total assets of these institutions amount to US dollars 31 billions. These institutions are spread in a number of countries and continents. The geographical distribution of these institutions in 1996 is given in the following Table/Chart.

Table-1

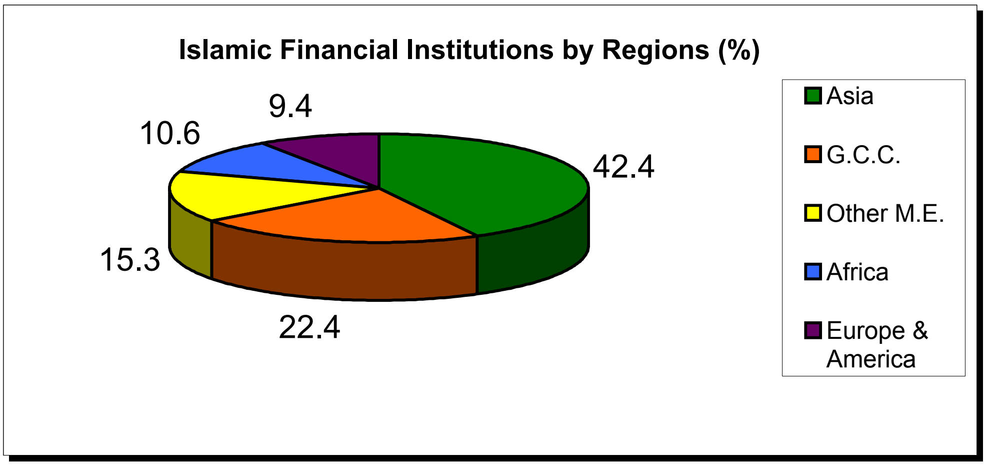
Islamic Financial Institutions by Regions

Region	Number of Institutions	%
South and South East Asia	36	42.4
G.C.C.	19	22.4
Other M.E.[1]	13	15.3
Africa	9	10.6
Europe and America [2]	8	9.4
TOTAL	**85**	**100**

Notes: 1.Includes Turkey, 2. Most of these are not endogenous. They are registered there for tax and some other advantages

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

CHART-1



These figures show that the largest number of Islamic financial institutions are in Asia followed by G.C.C and other Middle-Eastern countries. While this gives us an idea about the “spread” of Islamic banking, it does not obviously reflect the relative “strength” of Islamic banking in various regions. In order to see the relative “strength” of Islamic banking in various regions, the funds under management of Islamic banking and finance institutions in various regions are shown in the following table and chart.

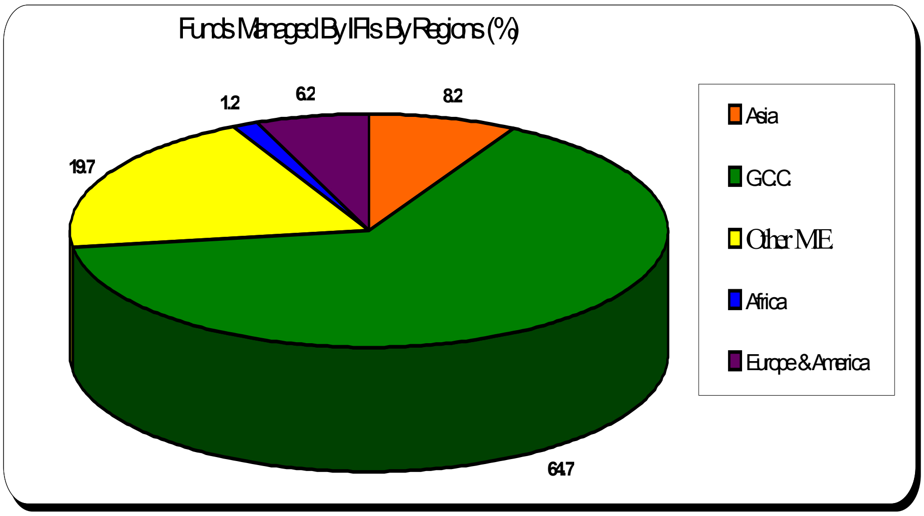
Table-2

Funds Managed by Islamic Institutions by Regions

Region	Funds Managed (US dollars millions)	%
South and South East Asia	2,250.7	8.2
G.C.C.	17,834.5	64.7
Other M.E.	5,430.1	19.7
Africa	334.5	1.2
Europe & America	1,723.0	6.2
TOTAL	**27,573.0**	**100.0**

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

CHART-2



It can now be seen that the bulk of the Islamic banking activity is concentrated in the Middle-East, especially G.C.C countries. This region accounts for about 84 percent of the total funds under management of Islamic banking and financial institutions.

2.4.1 Size

Size is an important variable to determine the efficiency of a bank. It determines the scale and scope efficiencies. Economists have shown that larger banks are in a better position to reach the optimum mix and scale of output. As a result, they are more x-efficient than smaller ones. The estimates with respect to the saving in costs due to scale economies range from 20 percent to as high as 50 percent. The literature on banking and finance indicates that there are substantial scale inefficiencies for small banks. Full efficiency has been found with a level of US dollars 500 million of assets. Inefficiency loss for banks below US dollars 100 million of assets amounts to about 10 percent. Scope diseconomies for small banks have been

found to range between 10-20 per cent, with huge scale economies for larger banks.[10]

The available data shows that Islamic banks and financial institutions are much below the optimum size. The average size of assets of these institutions was US dollars 395 million in 1996. However, this figure may be misleading because of extreme variations between the maximum size (US dollars 8.6 billion) and the minimum size (only US dollars 72 thousand). The standard deviation works out to be US dollars 1.2 billion (about four times the average) which points to the presence of extreme values in the data. In order to see a better picture, Table 3 summarizes the position of Islamic Banks and Financial Institutions (IBFIs) for which data was available, in a frequency distribution in terms of size of assets in 1996.

Table-3
Islamic Banks and Financial Institutions by Size of Assets 1996

Assets (US dollars Millions)	Frequency Distribution
0-50	39
51-100	13
101-200	4
201-300	3
301-400	8
401-500	1
500-1000	3
>1000	7
TOTAL	**78**

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

[10] For further details, see, Mabid Al-Jarhi, "Islamic Banks and Capital Markets: Current and Future Challenges", IRTI, (1997) mimeographed and the references quoted therein.

It may be observed that only 11 institutions are above the average figure. If we exclude Tabung Haji, Malaysia, which is a special purpose institution, there are only 10 financial institutions, which can be considered to be of optimal size from an economic point of view. More than eighty per cent of the institutions are below the optimal size of 500 million dollars. The small size of Islamic banks is a major hurdle in the way of minimizing risk through portfolio diversification.

In terms of the size of capital, economic literature[11] has determined that for banks under US dollars 1 billion, the optimum size (where average cost is minimum) is between US dollars 75-300 million. As the data in the following table shows, there are only eight institutions, which can be considered to have reached the optimum size in terms of capital.

Table-4
Islamic Banks and Financial Institutions by Size of Capital 1996

Size of Capital (US dollars Millions)	Frequency Distribution
0-25	55
26-50	10
51-75	6
76-100	2
101-150	2
151-200	2
201-300	2
TOTAL	**79**

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

From these statistics, it can easily be concluded that most Islamic banks and financial institutions have not reached an optimum size to be able to achieve efficiency. In addition to efficiency, there are some other reasons

[11] Op. Cit

to advocate larger size. A large capital base is one of the important factors influencing financial rating. It reflects shareholders' commitment to their business. That comes handy in case a bank wants to raise additional capital. In order to increase the level of efficiency and deal more effectively with financial markets, it is desirable that the size of operations of Islamic banks be substantially increased. In this regard, serious consideration may be given to mergers.

2.4.2 Financial Indicators

Some key financial indicators for Top Ten Islamic banks as well as Top Ten Middle-Eastern, Asian and World banks are given in Table 5 and discussed in the following paragraphs.

Table-5

Key Financial Indicators: Islamic Banks vis-à-vis Conventional Banks (1996)

(Percentages)

Indicator (1)	**Top Ten World** (2)	**Top Ten Asian** (3)	**Top Ten Middle-Eastern East** (4)	**Top Ten Islamic** (5)
Capital/Asset Ratio	4.8	4.2	7.6	9.7
Profit on Capital	16.1	17.2	16.3	21.8
Profit on Assets	0.9	1.1	1.5	1.4

Source: For columns 2-4, *The Banker*, July 1997. Column 5, computed from Statistical Tables in the Annexure-3.

Capital/Asset Ratio

There are three major reasons for a bank to watch its capital asset ratio. First, a minimum amount of bank capital is required by regulatory authorities. Second, the size of the bank capital has safety implications as it provides some cushioning, *albeit* limited, against the possibility that the bank cannot satisfy its obligations to its creditors. Third, the amount of

capital affects the rate of return to the bank's equity holders. There is a trade-off between return to the owners and the safety of the bank. Given the return on assets, the smaller the bank capital, the higher the rate of return to the owners of the bank. Therefore, the owners of the bank have a natural tendency to keep lower capital/asset ratios. But the lower capital/asset ratios increase the risk of bank failures. It is for this reason that the regulatory agencies prescribe certain minimum capital/asset ratios.

According to Basle Agreement (1988), the Basle Committee on Banking Supervision has defined international standards on banks' capital adequacy, which divide assets and off-balance-sheet items into four categories according to their degree of riskiness.

Once all the bank's assets and off-balance-sheet items have been assigned to a risk category, they are weighted by a corresponding risk factor and added up to compute the total "risk-adjusted assets." The bank must then meet two capital requirements: It must have "core" or Tier 1 capital (stockholder equity capital) of at least 4% of total risk-adjusted assets, and total capital (Tier 1 capital plus Tier 2 capital, which is made up of loan loss reserves and subordinated debt[12]) of at least 8% of total risk-adjusted assets. These are, however, minimum international standards. In most countries, a bank is considered to be well capitalised only if its total capital/assets ratio exceeds 10%.

In the absence of data on loan loss reserves and subordinated debt in case of Islamic banks, it is not possible to reach a judgement with respect to "total capital" requirements. However, it is possible to check the "core" capital requirements. As the data shown in Table 5 indicates, Islamic banks as a group are well above the standard set by the Basle Committee. The capital/asset ratio for Top Ten Islamic banks is 9.7 percent. While this average compares favorably with the top ten banks worldwide, Asia and the Middle-East, it must be noted that bigger banks, in general, can afford to keep a lower capital/assets ratio because they have a lower risk of a run on the bank. It should also be noted that under the conventional system, in addition to minimum capital/assets ratio, the depositors are protected, at

[12] Subordinated debt is debt that is paid off only after depositors and other creditors have been paid.

least partially, by deposit insurance. Under the Islamic banking system, there is no deposit insurance in general. Therefore, the capital/asset ratio needs to be kept higher.[13] On the other hand, it must also be noted, that higher capital adequacy ratios are needed to protect the rights of depositors in case of insolvency. One should keep in view the fact that under Islamic banking only demand deposits are guaranteed, while investment deposits are not. Investment depositors are required to share in the loss of the bank, if any[14]. Therefore, the liabilities of Islamic banks are automatically reduced in difficult periods. Considering all relevant factors, we can conclude that the capital asset ratio for Islamic banks as a group is quite good.

Profit on Assets

The average rate of return on assets for the Top Ten Islamic banks was 1.42 percent in 1996. This is comparable to the corresponding rates for the commercial banks in the categories mentioned in Table 5. However, it should be noted that conventional banks' depositors are guaranteed, and hence bear less risk than Islamic banks' depositors. Therefore, the latter would expect a higher rate of return to compensate for the extra risk. The current rates of profits on assets of the Islamic banks may not be enough to meet that expectation. Nevertheless, in a comparative framework, the performance of Islamic banks is not bad. However, there is a need for improvement. It should also be noted that the lower rates of profit for the top ten banks in the world as well as in Asia are due to the fact that some of these banks have posted losses during recent times, bringing the average rates down. These losses were mainly caused by bad debts. Therefore, one may conclude that Islamic banking as a model is performing well.

Return on Capital

The average rate of return on capital for Islamic banks during 1996 was 21.8 percent. This also compares quite favorably with the conventional banks. In addition to a better rate of return on capital, if one considers the fact that the capital asset/ratio of Islamic banks is higher than their

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[13] This applies not only in the case of Islamic banks but also to countries where no deposit insurance is available.

[14] As mentioned above, some Islamic banks bear some of those losses voluntarily in years when profitability is low, to protect their market share.

counterparts as mentioned above, one can easily conclude that Islamic banking as a business is doing reasonably well.

2.4.3 Financing Activities

Due to non-availability of detailed data for operational activities of most banks, for further analysis, a sample of 10 banks was selected. There were two main criteria for selection of this sample. One, the bank should be of a minimum size to have statistical significance. The second criterion was the availability of data. The banks included in the sample account for more than 50 percent of the total assets of Islamic banks in 1996. Therefore, we can safely assume that the sample reflects many of the characteristics of Islamic banks in general. Some empirical results based on this sample are discussed below. However, in view of the observations on the quality of data mentioned in Annexure-II, these results should be treated as indicative rather than definitive.

Modes of Finance

As mentioned in Section 2, while Islamic banks use *mudarabah* on the resource mobilization side, they use a number of financial instruments on the asset side. It is generally observed that the modes of finance used by Islamic banks are dominated by fixed-return modes, especially *murabahah*. The estimates of the use of various modes vary. There have even been conjectures that the use of profit-sharing modes has increased over time. In order to provide some empirical evidence on this issue, data was compiled for the period 1994-96. There is no perceptible change in the trend of use of these modes over time.

However, our time series is not long enough to make any judgement about movement over time. Instead, we pooled the data for these three years and computed three-year averages in order to minimize year to year variation. This will provide an idea about the extent of "current" use of the modes in a better way. One can then compare this with the extent of use of these modes in earlier periods from other studies.

The data for the period 1994-96 is given in Table 6. The results are summarized in Charts 3 and 4.

Table-6
Financing by Modes 1994-96 Averages

Name of Institution	Total Financing.	*Murabahah*	*Musharakah*	*Mudarabah*	*Ijara*	Others	*Murabahah*	*Musharakah*	*Mudarabah*	*Ijara*	Others
		Percentages					**US dollars (in thousands)**				
Albaraka Islamic Invest. Bank	118567	82.03	6.87	5.67	2.43	3.00	97264	8142	6719	2885	3557
Bahrain Islamic Bank	320072	92.63	4.93	1.93	0.00	0.50	296493	15790	6188	0	1600
Faysal Islamic Bank of Bah.	944967	68.90	9.00	6.33	10.97	4.80	651082	85047	59848	103631	45358
Islamic Bank Bangladesh Ltd	308813	51.70	3.57	17.10	14.07	13.57	159656	11014	52807	43440	41896
Dubai Islamic Bank	1299771	87.50	1.45	5.50	0.00	5.55	1137299	18803	71487	0	72137
Faysal Islamic Bank of Egypt	1364456	72.80	13.00	11.33	2.87	0.00	993324	177379	154638	39114	0
Jordan Islamic Bank	574289	61.62	3.74	0.39	4.67	29.59	353877	21459	2240	26800	169913
Kuwait Finance House	2454186	45.33	20.00	10.67	1.33	22.67	1112564	490837	261780	32722	556282
Bank Islam Malaysia Berhad	580259	66.33	1.30	0.67	7.37	24.33	384905	7543	3868	42746	141196
Qatar Islamic Bank	597703	73.00	1.00	13.33	4.67	8.00	436323	5977	79694	27893	47816
TOTAL (10 Banks)	8563083						5622789	841993	699269	319232	1079756
Simple Average		70.19	6.49	7.29	4.84	11.20					
Weighted Average*							65.66	9.83	8.17	3.73	12.61

*Total Financing has been used as weights.

Source: Compiled from the Directories of Islamic Banks and Financial Institutions (1994-1996), International Association of Islamic Banks, Jeddah.

CHART-3

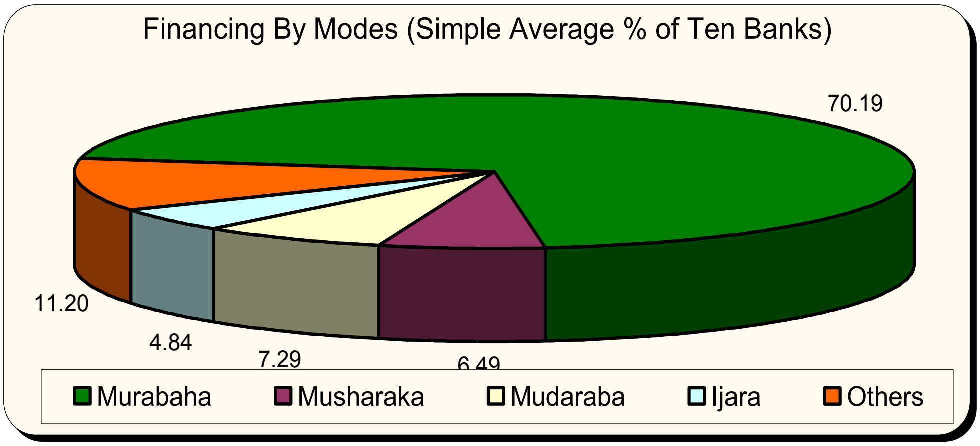
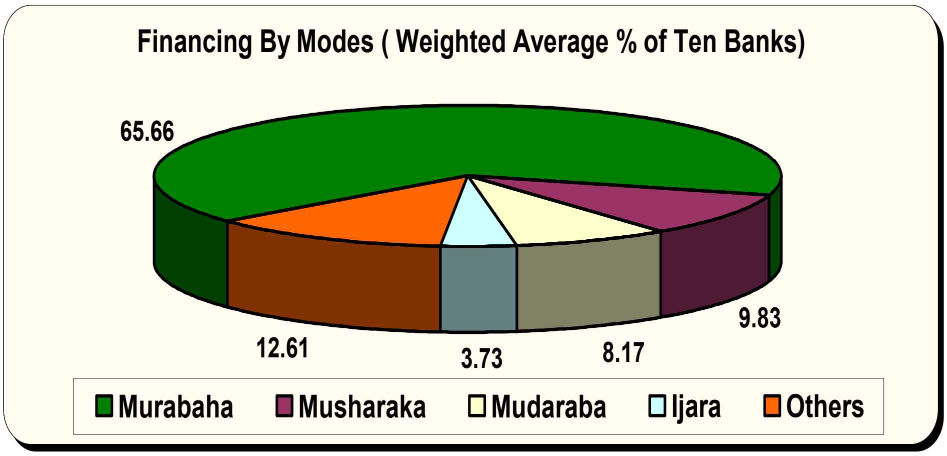


Chart 3 shows the use of various modes by simple averages of the ten banks. This indicates the "breadth" of use of various modes by various banks. The big and small banks are treated alike. It can be seen that *murabahah* accounts for 70 percent of total financing. *Ijara* accounts for another 5 percent.

CHART-4



Thus the fixed-return modes account for 75 percent of total financing. Even this is not all. The unspecified “Others” category takes another 11 percent. The profit-sharing modes account for less than 14 percent of financing.

Chart 4 shows the use of various modes after calculating weighted averages. This shows the “industry” position. *Murabahah* now accounts for 66 percent of total financing by Islamic banks. This drop in the percentage use of *murabahah* is almost entirely explained by lesser use of this mode by Kuwait Finance House (only about 45 %) which is the largest bank in the sample and hence carries a lot of weight.

Financing by Sectors

Once again, in order to examine the “current” position of financing by various sectors, we compiled three-year averages for the period 1994-96 in order to minimize inter-year variations. The data is given in Table-7 and summarized in charts 5 and 6.

Table-7

Financing by Sectors 1994-96

Name of Institution	Total Financing	Trade	Agriculture	Industry	Services	Real Estate	Other	Trade	Agriculture	Industry	Services	Real Estate	Other
		Percentage						**Total (US dollars in thousands)**					
Albarka Isl. Invest. Bank	118567	32.0	0.0	14.7	10.0	6.3	37.0	37941	0	17390	11857	7509	43870
Bahrain Islamic Bank	320072	84.6	0.0	0.9	0.7	6.1	7.7	270930	0	2774	2347	19524	24646
Faysal Isl. Bank, Bahrain	944967	35.7	4.1	15.0	8.3	8.2	28.7	337038	39059	141745	78747	77172	271205
Islamic Bank Bangladesh	308813	61.1	0.3	22.2	2.8	2.6	10.9	188788	926	68659	8750	7926	33764
Faysal Isl. Bank, Egypt	1364456	44.1	5.8	15.0	32.3	0.0	2.8	601270	79593	205123	440719	0	37750
Jordan Islamic Bank	574289	28.9	0.3	8.6	6.0	25.1	31.1	165816	1799	49293	34304	144223	178853
Kuwait Finance House	2454186	16.7	0.3	0.3	32.9	22.7	27.1	409031	8181	7363	807427	557918	664266
Bank Islam Malaysia Bh	580259	10.7	11.1	28.2	2.7	36.6	10.6	62088	64215	163826	15860	212568	61507
Qatar Islamic Bank	597703	68.0	0.0	2.3	5.3	8.3	16.0	406438	0	13946	31878	49809	95633
Total (9 Banks)	7263312							2479341	193774	670120	1431890	1076650	1411493
Simple Average		**42.4**	**2.4**	**11.9**	**11.2**	**12.9**	**19.1**						
Weighted Average*								**34.1**	**2.7**	**9.2**	**19.7**	**14.8**	**19.4**

*Total Financing has been used as weights.

CHART-5

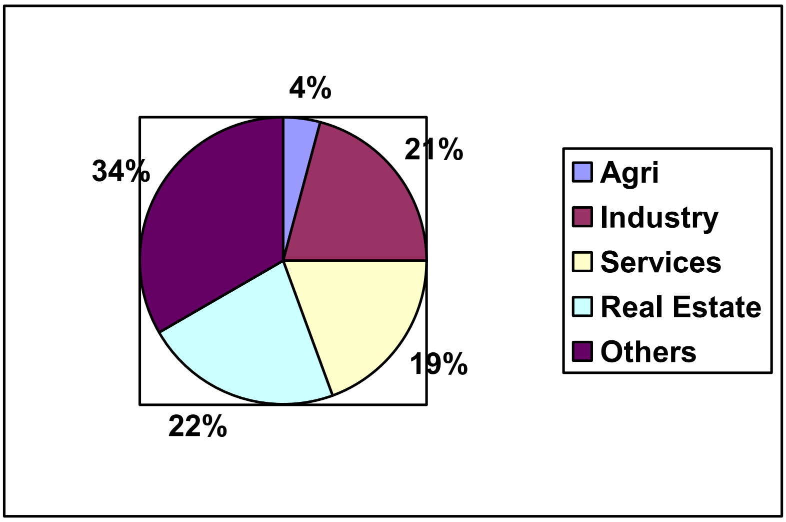


CHART-6

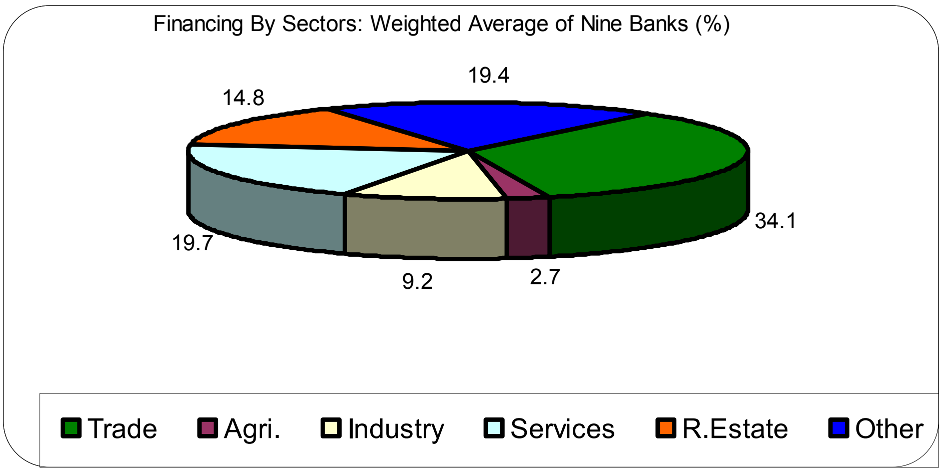


Chart 5 presents the picture for the ten banks on the basis of simple average. It is obvious from the data that in case of most of the banks, trading gets the biggest proportion of financing. The average for the ten banks works out to be 42 percent. The second largest sector is real estate which accounts for 13 percent of financing on the average. Agriculture claims only 2 percent and industry 12 percent of the financing.

The "industry" picture can be seen in chart 6 which gives the financing by sectors on weighted average basis. There is a slight change in the pattern. While trading is still the largest sector, services now explain 20 percent of total financing and become the second largest sector. Real estate claims 15 percent of total financing.

It may be noted that only 12 percent of financing provided by Islamic banks is flowing to the "commodity" sector i.e. agriculture and industry.

One reason for this pattern is again the dominance of *murabahah* as a mode of finance. *Murabahah*, as is well known, is basically a trading technique. It has not lost that character when it was turned into a financial instrument. Another reason is that the countries in which major Islamic banks are situated (i.e. G.C.C countries), do not have strong industrial and/or agricultural sectors.

Regardless of the reasons, the sectoral allocation of finance by Islamic banks is similar to that of conventional banks. This calls for rethinking the role of Islamic banks in economic development against the hopes which had been raised in the past regarding their ability to finance agriculture and industry.

SECTION 3
CHALLENGES FACING ISLAMIC BANKING: INSTITUTIONAL ASPECTS

Islamic banks have struggled for a quarter of a century, gaining some success yet facing some problems. It is, perhaps, the time to take stock of the challenges they face, especially that they will soon be ushered into a new millennium. This section deals with the challenges confronted on the institutional side, while the next section deals with the operational side.

3.1 Proper Institutional Framework

Every system has its institutional requirements. Islamic banks are no exception, as they need a number of supporting institutions/ arrangements to perform various functions.

Islamic banking institutions all over the world try to benefit from the institutional framework that supports conventional banking. However, they suffer from the lack of institutional support specifically geared to their needs. Building a proper institutional set-up is perhaps the most serious challenge for Islamic finance. To face this challenge, a "functional approach" towards building this set-up is proposed. The functions being performed by various institutions in the conventional framework should be examined and attempts should be made to modify the existing institutions in a way that enables them to provide better support, or establish new ones as needed.

3.2 Appropriate Legal Framework and Supportive Policies

The commercial, banking and company laws in most of the Islamic countries are fashioned on the Western pattern. Those laws contain provisions that narrow the scope of activities of Islamic Banking within conventional limits. While parties can structure their agreements according to an Islamic contract, the enforcement of those agreements in courts may require extra efforts and costs. Those conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. Such laws would facilitate the operation of Islamic banks side by side with conventional banks.

In addition, laws are needed to allow financial institutions to operate according to Islamic rules and to give room in financial markets for Islamic financial transactions. In that context, the legal framework of Islamic banking and finance might include the following:

Islamic Banking Laws

This set of laws will be concerned with the establishment, functioning and supervision of Islamic banking in the country. In several Muslim countries such laws already exist which have provided a framework for the working of various Islamic banks. In many others, only small modifications in existing laws can be sufficient.

Laws Concerned with Financial Institutions

Islamic non-banking financial institutions can operate with reasonable ease within the legal framework existing in many Islamic countries. In some others, some modifications are required to widen the scope of operations to cover Islamic financial operations.

3.3 Supervisory Framework

Supervision of Islamic banks is as important as that of the conventional banks. At present, lack of effective supervisory framework is one of the weaknesses of the prevailing system and deserves serious attention. The roles of both the *shari'ah* advisory boards and the Central banks need to be streamlined and strengthened.

There are three main reasons why regulation and supervision of banking industry are important: To increase the information available to investors (transparency), to ensure the soundness of the financial system and to improve control of monetary policy. In case of Islamic banks, there is an additional dimension of supervision. This relates to *shari'ah* supervision of their activities.

As to transparency, the present situation of Islamic banks leaves a lot to be desired. In many cases the most essential information such as the exact way of calculating the share of profits of different types of deposit holders is not made public. Similarly, details of the uses of funds by the banks are not declared. More transparency in various aspects of the activities of the Islamic banks will increase the confidence of clients and will help avoiding panics. The regulatory bodies must oblige the banks to reveal crucial information to the investors and thereby increase the efficiency of financial markets.

To protect the public and the economy from financial panics, most governments have created elaborate regulatory bodies. As a result, banking industry has become one of the most heavily regulated industries all over the world. Against this background, let us see the supervisory framework of Islamic banks.

In most countries Islamic banks are put under the supervision of the central bank of the country and are given the same treatment as given to conventional commercial banks. Some countries issue special Islamic banking Act to govern the operations of specific Islamic banks and their relationship with the central bank[15]. Some others issue laws that set general rules for the operations of Islamic banks side by side with conventional banks[16]. Central banks subject Islamic banks to the same controls, conditions and regulations that they apply to the interest based banks. However, there are certain factors, which require that Islamic banks should be treated on a different footing. Some of these factors are the following:

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[15] This was done in the cases of establishment of Islamic banks in Jordan and Egypt.
[16] As in Malaysia, Turkey and UAE.

a. Islamic banks, like all other commercial banks are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic banks cannot accept. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central banks.

b. Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most of Islamic banks function under the supervision of central bank, they cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. It is understandable that such assistance cannot be free of cost. However, there is a need to devise and implement an interest-free framework for such assistance. The Pakistan Council of Islamic Ideology suggested a profit-sharing mechanism whereby profit can be calculated on "daily-product" basis.[17] Another suggestion is to build a "common pool" by Islamic banks under the supervision of central banks to provide relief to one another in case of liquidity problems on cooperative basis[18].

c. Legal reserves imposed on deposits with conventional banks are meant to meet possible withdrawals, whose rates vary between demand, saving and time deposits. This may apply to the same extent only in case of Islamic banks' demand deposits. However, the *mudarabah* deposits are like bank equity. Therefore, Islamic banks should not be required to maintain reserves against them just as equity capital is not subject to those reserves[19].

d. In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of interest-based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.

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[17] Council of Islamic Ideology, *Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy*, Islamabad, 1980.

[18] M. Umar Chapra, *Towards a Just Monetary System*, The Islamic Foundation, Leicester, U.K., 1985.

[19] For further arguments in favour of this proposal, see Chapra, ibid, p.161.

e. Lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for rather inappropriate policies of the central banks towards Islamic banks. This is particularly true of *musharakah* and *mudarabah*. In debt financing, granting a loan by a bank is a one-time activity, no matter what is the size of the loan. But *musharakah* and *mudarabah* are on-going activities and participation of an Islamic bank in these activities continues as long as the project financed is in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks.

f. Central bank regulators are sometimes unclear about the exact role of the *Shari'ah* Boards. It is sometimes felt that these Boards may interfere in the banks' decisions with regard to monetary policy tools such as reserve requirements, open market operations, etc. It would be desirable to determine the exact role of the *Shari'ah* Boards and take the central bankers into confidence.

3.4 Accounting Standards

Conventional banks have similar accounting standards even across countries. Central banks publish the aggregated balance sheets of the banks and supervise regularly and without difficulty. In contrast, dissimilarity of accounting practices among Islamic banks go to the extent that any meaningful comparison between their balance sheets or profit and loss accounts becomes a very difficult task if not altogether impossible. Furthermore, the concepts used in the balance sheets or profit and loss statements are not rigorously defined.

However, during the last few years some headway has been made to overcome this problem. In order to introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks, under the guidance of the Islamic Development Bank, have established an organization called, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The organization, now functional and based in Bahrain, is composed of a supervisory committee and a Financial Accounting Standards Board responsible for preparing, issuing and

amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board. However, it will be sometime before any perceptive change in the accounting practices of Islamic banks is observed. The major reason for this is that AAOIFI is a voluntary organization and has no binding powers to implement its standards.

The Need for an Autonomous *Shari'ah* Supervisory Board

Banking supervision is needed in case of Islamic banks as much as in case of conventional banks. However, because of the special nature of operations of Islamic banks, it has different control and supervisory requirements. There is also an additional dimension of supervision in case of Islamic banks. This relates to *shari'ah* supervision of their activities. At present, most Islamic banks have their own *shari'ah* Boards. Questions have been raised about the autonomy and powers of these Boards. *Shari'ah* Boards of different banks could issue different rulings on similar practices which may raise doubts in the minds of clients. Minimum *shari'ah* standards for each type of contract issued by an autonomous body will go a long way to assure customers of the "*shari'ah* compatibility" of those contracts as well as actual operations. This need becomes more important in the wake of the entry of several Western banks in Islamic banking.

In view of these considerations, it is proposed that an autonomous *Shari'ah* Board for supervising the *shari'ah* side of Islamic banks may be constituted. It must be mentioned here that since Islamic banks do not fall under the jurisdiction of a single Government, such a Board can be constituted only if the Islamic banks agree to abide by a common discipline. They must realize that doing so will be in their own long run interest. If Islamic banking is not **perceived to be** "Islamic", it will not be long when the existing Islamic banks will lose much of their market.

3.5 Lack of Equity Institutions

In all businesses there is need for long term finance. In conventional system, this is provided through long term bonds and equities. This function is performed by securities markets and specialized equity institutions. In addition to the general public, the most important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest-bearing bonds. Therefore, their need for equity markets is much higher. It may be mentioned here that even in conventional finance, there is an increasing trend towards the use of equities as a source of business finance. As may be seen in the following Table, equity markets have shown phenomenal rates of growth in recent years throughout the world.

Table-8
Growth of Equity Markets in Selected Countries

(Values in US dollars Millions)

Country	**Capitalization**			**Annual % Rate of Growth 1986-90**	**Annual % Rate of Growth 1990-95**
	1986	1990	1995		
Bangladesh	186	321	1323	14	32.74
Egypt	1716	1765	8088		35.59
India	13588	38567	127199	29	26.96
Indonesia	81	8081	66585	216.	52.47
Korea	13924	120594	181955	71	8.57
Malaysia	15065	48611	222729	34	35.58
Morocco	279	966	5951	36	43.85
Pakistan	1710	2850	9286	13	26.65
Turkey	935	19065	20772	112.	1.73
France	149500	314384	522053	20	10.68
Germany	257677	355073	577365		10.21
Japan	1841785	2917679	3667292	12	4.68
UK	439500	848866	1407737	17	10.65
US	2636598	3059434	6857622		17.52
World Total	6514399	9393545	17787883		13.62

Source: International Finance Corporation, *Emerging Stock Markets Factbook*, 1996

Unfortunately, in most of the Muslim countries, which are the natural domain of Islamic banking, security markets are not well established. Similarly, the number of specialized equity institutions and other institutions which traditionally provide equity capital through stock exchange i.e. pension funds, mutual funds[20] and insurance companies is negligible. Recently some mutual funds and *mudarabah* companies have been established in some Muslim countries but their number is very small and they are not well known to the general public. Moreover, information about their performance is extremely limited.

Pension Funds are mostly restricted to the public sector. There are hardly any private or even corporate sector pension funds. The number of Islamic insurance companies is less than a dozen throughout the Muslim world. For reasons explained later in the paper, Islamic banks have shied away from big exposures in equity investments for practical reasons which cannot be trifled with. In view of the importance of long term capital for economic growth, establishment of institutions providing equity capital is a prerequisite for the survival and success of Islamic finance.

Islamic financial institutions have to take note of recent developments in international financial markets. All over the world, savers are deserting traditional bank accounts and low yielding government bonds by the thousands. As a result, stock markets are witnessing high rates of growth as well as substantial increases in stock prices. A massive reallocation of wealth is taking place. Institutions like Mutual Funds and Pension Plans are ballooning. In the United States, the relative share of Pension Funds in the total assets of financial intermediaries has increased from 17.4 percent in 1980 to 25.2 percent in 1995. Similarly, the share of Mutual Funds has gone up from 3.6 percent in 1980 to 15 percent in 1995. The share of depository institutions decreased from 60 percent to 37 percent in the same period. In United Kingdom 10 percent of all new savings are finding their way into Stock Funds. British savers held US dollars 65 billion in Personal Equity Plans in 1997, as compared with US dollars 3.8 billion in 1990. The net assets of Italian Mutual Funds soared from US dollars 123 billion to US dollars 206 billion in 1997 alone. French Stock Funds

[20] Most of those direct a good part of their resources to financial markets in the industrial countries.

increased by 48 percent while Spanish Equity Funds tripled. German investments in Mutual Funds have been growing by 20 percent a year since 1990. Virtually all of this money was diverted from bank accounts. Stocks, which represented only 18 percent of European household savings in 1992, now account for more than 26 percent.[21]

The challenge posed by such developments to Islamic banks is that they must prepare themselves quickly to be involved in increasingly active and growing equity markets. Giving more importance to "fund management" and building more stock companies, mutual funds, and offering equity-based instruments are some of the action required.

3.6 Establishment of Organised Secondary Financial Markets

Banking thrives on the existence of secondary financial markets. The commercial banks invest in very short-term financial assets, which they can convert into cash very quickly at negligible conversion cost. There are several ingredients of a secondary financial market: financial papers, dealers, and financial institutions. Various kinds of financial assets such as securities, bonds, shares, debentures, commercial papers are the financial instruments. Merchant banks, investment banks, mutual funds, investment funds etc. are the financial institutions. Then, there are a large number of buyers and sellers who deal in these financial papers.

Islamic banks, like conventional banks can gain a great deal from establishing secondary markets in their own countries. This would help making their assets more liquid as well as attractive to savers, thereby increasing their ability to mobilize funds.

3.7 Need for Market for Short-term Placements of Funds

Most of the Islamic banks exist as single entities. The strength of commercial banking is derived not from individual institutions but by taking all banks together. Inter-bank transactions among Islamic banks are minimal because in most of the countries the number of Islamic banks is very small. The evolution of short-term financial assets which Islamic banks may hold

[21] Time, April 27, 1998.

and transact among themselves shall go a long way towards making an Islamic money market a reality.

Commercial banking during the last few years of the twentieth century is characterised by two factors: First, it deals with a large amount of deposits. Second, the turnover has become faster and faster. Application of modern means of telecommunication have made it possible that billions of dollars are transferred from one continent to the other, in a few hours. Thus, the opportunity cost of holding short-term funds has increased tremendously.

Islamic banks lack such short-term instruments in which they can profitably invest for short periods. Modern commercial banks can lend each other millions of dollars even for a day. They can also calculate interest on a per day basis. Islamic banks are in a relatively better position with respect to unexpected liquidity demands of the depositors since a large proportion of their deposits are fixed term. Still there is a significant proportion of depositors who would prefer fixed term deposits with options to withdraw in case of need. In addition, there are saving deposits which bear a rate of return and can also be withdrawn within certain limits. Therefore, Islamic banks do need instruments as well as institutional arrangements for short-term placement of funds. While the need for overnight placement of funds may not be very pressing in case of Islamic banks, there is still a need for a market for short-term placements of funds.

SECTION 4
CHALLENGES FACING ISLAMIC BANKING: OPERATIONAL ASPECTS

4.1 Financial Engineering[22]

"Financial engineering", as the word indicates refers to the art of designing financial products to meet the needs and tastes of the users with regard to risk, maturity and yield. Financial markets are becoming more and more sophisticated, and competitive. In order to exploit the fast changing market environment and face increasing competition, financial engineering and innovation is imperative. Until now, the Islamic financial tools have essentially been limited to classical modes developed centuries ago. They were developed to meet the needs of those societies. While they may serve as useful guidelines for contemporary Islamic contracts, there is no reason to be restricted only to those.

In the light of the principles of *maslaha* and *istihsan*, a "needs approach" to financial engineering is desirable, of course within the known principles of Islamic finance. In this regard, the example of *bai' salam* is very important to remember. In general, it is not allowed to sell anything, which is not in one's possession. But in case of *salam*, the Prophet (pbuh) allowed such sale because of "need" of the people, but laid down clear rules to protect the interests of both parties. Financial needs of both individuals and businesses have changed. Engineers in modern finance have designed several new ways such as mortgages, options, derivatives, hedging, insurance pension plans, credit cards etc., to meet those needs. We must

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[22] The term is being used here in its broad sense to mean development of new financial products in all areas of financial operations including resource mobilisation, placement of funds and risk management, etc.

examine what needs are being fulfilled by these instruments. If the needs are genuine (Islamically speaking), then we must either adapt them for our purposes or invent Islamic alternatives for them.

The process of adaptation is well recognized in Islamic *fiqh* and has never stopped. However, its speed needs to be greatly enhanced. Classical contracts have been modified in a number of cases to meet current needs. One potent example is the initiation of Islamic banking on the basis of *al-mudarib udarib* principle, which provides that a *mudarib* (agent) may himself appoint another agent to actually run the business. Another is the practice of *murabahah*, through which the bank buys merchandize upon the promise of another party to purchase it from the bank at a higher price.

The principle of *al-mudarib udarib* essentially allows for sub-contracting. If the principle is acceptable, there is no reason to restrict it only to *mudarabah*. Contracts can also be designed on the basis of other principles, like *al-muajjar uajjir*, *al mustasna'* ya*stasna'*, etc. In other words, the original contractee may arrange to fulfil the obligations under the contract through third parties. That the principle is acceptable from an Islamic point of view is not questionable.

While it is possible to modify classical contracts to suit modern conditions, a much broader scope for financial engineering exists in developing new contracts. These contracts could be hybrids of old contracts or may be entirely new. The scope for financial engineering, and for that matter for innovations in other fields, is quite wide. It is important that the task is given over to those experts who know the needs and niceties of the trade. The final contract may be, say a, *Leasalam* contract (a combination of leasing and *salam*), a *Ijarka* contract (a combination of *ijara and musharakah)* or even an entirely new product.

4.2 Some Other *Shari'ah* Issues

Because of the religious dimension of Islamic banking and finance, no new product can be adopted until it is cleared by *shari'ah* scholars. Even after a new product is put into use, *shari'ah* auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of *shari'ah*. This is important not only for

religious reasons but also for purely business considerations because the clients of Islamic banks will not have confidence in their operations unless *shari'ah* scholars clear their activities. In this background, the expertise of *fiqh* scholars in understanding the pre-requisites of modern financial products and in evaluating these products becomes very important.

Almost all Islamic banks have their own *shari'ah* boards or *shari'ah* advisers. A survey of the members of these boards would reveal that hardly any of these scholars have a formal training in modern finance. They are using a number of ways to acquire the necessary background information before issuing a *fatwa*. One way is to discuss an issue in meetings/ workshops attended by both *shari'ah* scholars and financial experts. Institutions working in the field of Islamic economics, banking and finance are playing an active role in organizing such workshops. However, these workshops have no mandate to issue a *fatwa*. For that purpose, the meetings of the *Fiqh* Academies, the most prominent among which is the OIC *Fiqh* Academy in Jeddah, play an important role. Those academies also commission a number of studies by specialized experts on specific issues before discussing them and taking a decision. In the absence of the required expertise in the field of finance among *shari'ah* scholars, this approach of group *ijtehad* is playing an important role in safeguarding against serious mistakes in adopting doubtful instruments.

The situation is, however, far from being ideal. As any participant of the workshops and meetings of the *Fiqh* Academies can notice that the interaction between *Fiqh* scholars and the experts of modern economics and finance does not always proceed smoothly. They have so different backgrounds and speak such different technical languages that the communication between them requires special effort. It is, therefore, quite understandable that the *shari'ah* scholars are cautious in giving their rulings. The result has been that the *fatwa*-giving process has become extremely slow and tends to be over-conservative.

The past record shows that *shari'ah* bodies have done a commendable job in evaluating the applications of classical contracts. However, when it comes to evaluating modern financial contracts or Islamic substitutes for them, *shari'ah* bodies have found it quite difficult to issue verdicts. This is basically due to an acute shortage of scholars with dual

specialization or at least having working knowledge of modern finance and *shari'ah* at the same time.

Another important issue relating to the *shari'ah* boards is to determine their exact role. As mentioned before, questions have been raised about the autonomy and powers of these boards. "Supervision" by definition implies autonomy and independence in decision-making. This does not seem to be the case. Furthermore, *shari'ah* boards of different banks could issue different rulings on similar practices which may raise doubts in the minds of clients. Minimum *shari'ah* standards for each type of contract issued by an autonomous body will go a long way to assure customers of the "*shari'ah* compatibility" of those contracts as well as actual operations. This need becomes more important in the wake of the entry of several Western banks in Islamic banking.

4.3 Teaching, Training, Research and Development

Teaching, training and research are the wherewithal for the development of any discipline. This is more so for a discipline like Islamic banking and finance, which is still nascent. As mentioned above, there is a serious shortage of scholars who possess even a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly, many managers of Islamic banks are not very well trained in the use of Islamic modes of finance. Unfortunately, very little effort has been made to meet these requirements.

In the area of teaching, some universities in some Muslim countries particularly, Egypt, Saudi Arabia, Pakistan and Malaysia have initiated some teaching programs to produce graduates with the dual specialisation. However, a close examination of their curricula would reveal that they are not well designed to achieve this objective. This may also be confirmed by the fact that the Islamic banks have not been able to find a reasonable number of suitable managers from the graduates of those universities nor could anyone of them find a place in the *shari'ah* board of any Islamic bank.

In the area of research, the Islamic banks, neither individually nor as a group spend enough amount on research and development. Some Islamic banks have small units for research but very little of this research activity is

designed for product development. It is, therefore, not surprising that the Islamic banking industry has not been able to produce enough new financial products. The Islamic universities and the few research institutions working here and there have not received any substantial financial assistance from Islamic banks. Another very important component for useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. There is no consistent data series on the activities of Islamic banks for a reasonable number of years available anywhere. Whatever little information is available, is also subject to a number of qualifications as explained in Annexure-II.

In the area of training, a small effort was made in early 1980s by establishing a training institute in Cyprus. Due to certain reasons, this institute has been closed. The managers of Islamic banks may have been attending some short-term courses either on the job or elsewhere but there are not many formal training programs meant to prepare the employees of the Islamic banks for the needs of the system. Most of the employees of the Islamic banks, including the managers and financial experts come from traditional sources lacking necessary expertise in Islamic banking. An institution is what its employees make it. Therefore, it is extremely important to have the people with the right kind of skills and commitment.

The future of Islamic banking and finance crucially depends on teaching, training and research in the desired specialisation. There is also a need to arrange short courses for *shari'ah* scholars in economics and finance and similar courses for economists in *shari'ah*. The efforts in this area need to be enhanced to several times of current levels.

4.4 Lack of Profit Sharing Finance

Islamic financial transactions are two kinds. One is based on fixed charge on capital and the other is based on profit sharing. Both kinds provide finance through the purchase and sale of real commodities. Conventional financial transactions are based on lending and borrowing of money for a fixed charge (interest).

Islamic economics specialists built up their hopes on Islamic banks to provide a significant amount of profit-sharing finance. This would have

economic effects similar to direct investment and produce a strong economic development impact. Theoreticians have provided some arguments in favor of profit-sharing finance over fixed return-on-capital finance[23].

However, in practice, profit-sharing finance has remained negligible in the operations of Islamic banks. Reasons for this are numerous seen from the perspective of the Islamic banks and their clients.[24] From the perspective of firms as fund users, it is important to note that those financial contracts, which do not impose restrictions and encourage re-investment of earnings in the firm's growth, are more preferable. The profit sharing contracts have not been properly adapted to this requirement of firms as ongoing concerns. From the perspective of the banks, it appears that there are significantly higher costs of placing funds on profit-sharing basis. The choice of the right project to finance requires feasibility studies, technical and financial evaluation. The cost of such effort usually exceeds that of fixed return placements. In addition, profit-sharing arrangements require follow-up and provision of technical and sometimes additional financial support to entrepreneurs. In all cases project managers must have a good accounting system and be subjected to scrupulous auditing.

The modes of financing being used by most Islamic banks are dominated by fixed-return modes such as *murabahah* and leasing as shown by the empirical evidence given in section 2.4. Such modes are clearly distinguishable from interest-based modes since transactions with these modes are always done through real commodities.

The Islamic banks can be encouraged to provide more profit-sharing finance, if arrangements are made to reduce the costs involved by institutional appropriate arrangements as well as financial engineering consistent with the preferences of fund users. The benefits of direct investment in terms of economic development may not always be fully

[23] See, Abbas Mirakhor, "Progress and Challenges of Islamic Banking", *Review of Islamic Economics,* Vol. 4, No.2 (1997)

[24] See, Tariqullah Khan, "Demand for and Supply of Profit-Loss-Sharing and Mark-up Funds in Islamic Banking: Some Alternative Explanations", *Islamic Economic Studies*, Vol., 3 No. 1, 1996.

reflected in the rate of return. However, they occur to the society as a whole. It may, therefore, pay to support the involvement of Islamic banks into profit-sharing finance through some of the following arrangements.

a. Take care of the genuine concerns of the clients with regard to their requirements and preferences for funds,
b. Undertake entrepreneurial promotion activities by using appropriate incentive compatible financial arrangements,
c. Giving tax incentives to companies working on project feasibility studies and their evaluation,
d. Giving Islamic banks tax incentives to use the services of investment auditing companies,
e. Enforcement of sound accounting practices on small and medium size enterprises, and
f. Creating a special department in Central banks through which information of project feasibility and evaluation can be exchanged in addition to provision of technical assistance to Islamic banks when needed.

Banks, under the present circumstances, cannot afford to increase their risk exposure to any large extent. The emphasis should rather move to a greater reliance of businesses on equity and smaller reliance on credit. For this purpose attempts should be made to increase the number of equity institutions such as mutual funds, unit trusts, etc. Nobody denies that *murabahah* and leasing are permissible modes of financing. They also have some desirable features such as simplicity, convenience and safety.

Under present circumstances, financing modes like *murabahah* are indispensable. They are serving a useful purpose, that of providing investors high liquidity with low risk. Until proper institutional set up is built and needed products, including those for managing risk are developed, it may not be advisable to drastically increase the use of risky modes. However, several problems have been noted in the way *murabahah* is being used. Serious attempts should be made to "cleanse" the "quasi" *murabahah* being practiced by many banks at present of the undesirable features, to make it

"genuine" *murabahah*. Islamic banks must ensure that the conditions specified by jurists for the use of these modes are strictly observed.

However, an overwhelming use of these modes by Islamic banks in the absence of other Islamic financial institutions has led to some undesirable results for Islamic finance scene. These include:

4.4.1 Defaulters and the Issue of Compensation and Penalties

By using fixed rate modes of financing, the Islamic banks are able to side step the problems of moral hazard and adverse selection. But precisely because of the same reason, i.e., use of debt as compared to equity, they land themselves into a serious problem. *Murabahah* deals create debt obligations against buyers. Now, while it is permissible to charge a higher price in credit sales as compared to cash sales, the wherewithal of *murabahah* mode of financing, once the deal has been entered, it creates a fixed liability. If the buyer defaults on his payment, banks cannot charge anything extra because that would mean taking *riba*. Thus, there is a built-in incentive for immoral buyers to default.

Islamic jurists have been discussing this problem. It is generally agreed that penalties, both physical and financial, can be imposed against defaulters but the bank cannot get any benefit out of these penalties. Many contemporary scholars have argued that the banks can be compensated because a damage has been caused by the defaulter and Islam permits, rather encourages compensation of damages. The issue still remains unresolved.

4.4.2 Illiquidity of Assets

Another problem caused by the predominance of debt-based modes of financing is that it is difficult to transform these financial modes into negotiable financial instruments[25]. Once a debt has been created, it cannot be transferred to anyone else except at par value. This renders the whole structure of Islamic financial market as highly illiquid. This is one of the major obstacles in the development of secondary markets in Islamic financial instruments. Unless equity-based modes become more popular or

[25] With the exception of *ijara*.

other negotiable instruments are developed, the Islamic financial markets will remain undeveloped. Some attempts are being made to develop negotiable instruments based on *ijara* and *salam*. However, these have not been used to any significant extent so far. The major hope for developing Islamic secondary markets lies in a wider application of equity-based financial instruments and securitization of some of the existing modes.

4.4.3 Short-Term Asset Structure

Banks everywhere prefer short-term investments. This is so because they work on the basis of small reserves. They have to have the ability to liquidate their assets fairly quickly, if the need arises. In the case of Islamic banks, the short-term structure of their assets is even more pronounced. This also has to do with the predominance of *murabahah* among the modes of finance. *Murabahah*, a trading practice, by its very nature is a short-term contract. Even though it is conceivable to design an installment sale *murabahah* contract spreading over many years, the needs for which the *murabahah* contract can "genuinely" be used are, by and large, short term. Therefore, *murabahah* deals entered into by the Islamic banks have been and are going to be largely short term. Since *murabahah* comprises a very large percentage of Islamic banks' investments, the structure of their assets has also become short-term.[26]

Is it a problem? There are needs for financial resources on a long-term basis, e.g., venture capital. In the conventional framework, these needs are met by the other financial institutions such as securities markets. For this purpose equities need to be a major activity in the financial market. The problem assumes a more critical dimension in view of the fact that in most of the Muslim countries, the major domain of Islamic banks, well developed securities markets do not exist.

It must, however, be emphasized that providing these needs is the responsibility of the financial system as a whole. It is unfair to expect that Islamic banks should provide an alternative for all kinds of needs. There is

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[26] Mirakhor, Abbas, (1987), "Short-term Assets Concentration in Islamic Banking" in Mirakhor, Abbas and Khan, Mohsin, (eds.), *Theoretical Studies in Islamic Banking and Finance*, Texas: The Institute for Research and Islamic Studies 1987.

an urgent need to establish other financial institutions for performing those functions.

The situation is also ripe for establishing equity-based institutions and instruments. As mentioned in an earlier section, there is now a world wide trend for establishing equity institutions such as mutual funds. Savers are now increasingly recognising the benefits of profit-based instruments. The appeal of rate-based investment is waning. Although stock market investments have not become any less risky over the years, savers are beginning to accept the historical evidence that in any five year period since World War II, with one exception, stocks have produced higher returns than bank accounts, bonds or bullion.

There is also an historic opportunity of taking advantage of privatisation programs going on in many Muslim countries. A number of public companies, many with good track records and bright prospects are being offered to private parties. Islamic banks and financial institutions can take advantage of this opportunity. It must be noted, however, that leading *shari'ah* institutions have ruled that it is not permissible to take equity stake in companies which deal in interest even in small proportions. While this rightly reflects the serious concern that Muslims must garner against the use of interest, it puts a serious constraint on placement of funds. It closes an important market to Islamic banks and also exposes many big corporations in Muslim countries to foreign ownership. The matter needs serious consideration with a view to find an acceptable solution on the basis of a common need.

4.5 Mobilisation of Deposits and Endogenising Placement of Funds

As mentioned above, Islamic banks have shown tremendous success in mobilising deposits in the past. However, it will require much more strenuous efforts to maintain even a relatively modest rate of growth in the future. It must be realised that much of the deposits now with the Islamic banks came not due to the attraction of higher returns but because of the religious commitment of the clients. Many of them were keeping their savings in conventional banks without taking any interest and many others were keeping them “under their pillows”. For all such persons, a modest

return or even no return from Islamic banks, was acceptable. Now, most of this money has already found its way into the coffers of Islamic banks.

As conventional banking and financial institutions apply their vast experience to establishing financial instruments that conform to Islamic modes, Muslim savers will continue to find alternatives to depositing their cash in Islamic banks at lower rates of return. Competition from other institutions is gradually introducing new realities to the Islamic banking industry. Therefore, it is reasonable to assume that the rate of growth of deposits of the Islamic banks will be much lower unless they are able to attract deposits on competitive basis and from new sources. As a matter of fact, this is already happening. A recent study shows that the rate of growth of deposits in major Islamic banks has slowed down in the nineties.[27]

This has serious implications for the profitability of Islamic banks. Deposits constitute a very important source of investible funds. The data for the Islamic banks in our sample show that deposits are 15 times the owners' capital.

While Islamic banks and investment funds have so far mobilized huge financial resources, a large part of these resources have found its way into Western financial markets. Likewise, the same thing happened with resources mobilized with conventional banks. There is no Islamic (or for that matter, conventional indigenous) financial institution which has been able to channel savings from Western countries into Muslim countries in spite of the great demand for such resources in the latter countries. This is another challenge for Islamic banks with very important implications for Muslim countries.

4.6 Competition

So far, Islamic banks had a fairly large degree of 'monopoly' over the financial resources of Islamically motivated clients. This situation is changing fast. Islamic banks are now facing ever increasing competition. An important development in Islamic banking in the last few years has been the

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[27] Ahmad, Ausaf, *Structure of Deposits in Selected Islamic Banks*, Islamic Research and Training Institute, Jeddah, 1997.

entry of some conventional banks in that market. Although, it is difficult to know with certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short list may contain some of the giants of international banking business such as Chase Manhattan, Citibank, ANZ Grindlays, Klienwort Benson along with others such as Union Bank of Switzerland, Girozentale of Australia, the ABC International. In addition to these, in many Muslim countries, several commercial banks are offering Islamic banking services. Bank Misr in Egypt and National Commercial Bank in Saudi Arabia have opened Islamic Branches. In Malaysia, commercial banks have been permitted to open Islamic banking windows.

While this development is recognition of the viability of Islamic banking, does it augur well for the future of Islamic banking? The answer may not be very simple. In general, competition is supposed to be good for the growth of any industry. It forces inefficient firms to either shape up or ship out. It reduces the costs and improves services to consumers. It promotes innovation and brings improvements in product quality.

There is one exception to this rule. This is the well-known infant-industry argument which states that small firms in their infancy may be protected from harsh, ruthless competition until they can stand on their feet and be able to face competition from their bigger counterparts. One may argue that Islamic banks may well deserve that treatment. Conventional banks, particularly western banks have a large advantage over Islamic banks in terms of their experience and long standing in the market. Their systems, procedures, techniques of product innovations, marketing strategies, diversification in portfolio, are much superior to those of Islamic banks. This exposes Islamic banks to an unequal competition. On the other hand, it may be argued that such competition may be good for Islamic banking as western banks may bring their efficiency, market research and innovative capabilities, sophisticated banking and result oriented approach to Islamic banking which may lead to the development of new products and provision of better services to consumers.

While it may be difficult to settle the point on theoretical grounds, the stark reality is that even if one could invoke infant industry entitlements for Islamic banks, there is no institutional arrangement to put those in

operation. Infant industry benefits are usually offered by governments in terms of tax concessions or provision of subsidies. No such possibility exists at present. Therefore, the survival of Islamic banks essentially depends on their own efficiency. As mentioned earlier, at present more than 85 percent of Islamic banking in the corporate sector is concentrated in the hands of Islamic banks of GCC origin. This is going to be at stake in the near future due to competition from West-based multinational banks. Indigenous banks of Muslim countries will have to increase their efficiency substantially in order to keep a reasonable share of the market.

There are some other genuine concerns about the entry of large multinational banks into Islamic banking market. Naturally, their motives are purely commercial. They view it as a lucrative business opportunity. That is fair enough. However, serious doubts have been expressed as to whether they are following the rules of the game. It is apprehended that conventional banks may not follow correctly and faithfully the percepts of Islamic banking. In all major Islamic banks, there is a *shari'ah* board which regularly reviews the operations and contracts of the bank to determine their compliance with the requirements of the *shari'ah*. Similar arrangements do not exist at the conventional Western banks in most cases. It is also suspected that conventional banks may not be able to keep fully separate accounts for their Islamic banking operations. In the event they do mix "Islamic money" with their general pool of investible resources or they do not keep separate accounts for Islamic banking activities, there is a strong possibility that permissible (*halal)* returns may be 'contaminated' by *riba*.

There may be a silver lining, however. Even under competitive conditions, there is room for product differentiation. It is well known that the bulk of deposits of Islamic banks come from individuals with strong commitment to religious principles. Serious concerns have been expressed with respect to "*shari'ah* compatibility" of certain practices of Islamic banks. The entry of Western banks in the market has increased those concerns. Under these circumstances, Islamic banks are in a better position to allay those fears by paying attention to criticisms of some of current practices in Islamic banking. Practice of "genuine" risk sharing and increasing the use of more variable return modes will "differentiate" their products and hence will enable them to keep a niche of the market.

4.7 Globalization

The competition from conventional banks is expected to increase further in the near future due to globalization. Globalization refers to "growing economic interdependence of countries worldwide through the increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and widespread diffusion of technology".[28] Due to liberalization, the world markets are rapidly converging into a single market place. This poses opportunities as well as challenges for Islamic banks. On the one hand, it will allow more portfolio diversification and hence reduce the risk in profit sharing modes. This will open up opportunities for Islamic banks to increase the use of such modes. It is also expected that Islamic banks may be allowed to open more and more branches in non-Muslim countries. The possibilities of further deposit mobilization by Islamic banks are the greatest in this area, especially in the Muslim communities of these countries. On the other hand, they should also be prepared for more intense competition from foreign banks. To benefit from the opportunities offered by globalization, the Islamic banks need to improve the quality of their services and develop suitable products. Once again, customers will be the ultimate benefactors.

Technological innovations have played a more important part in financial integration and globalization. Electronic banking and widespread use of computers in banking has transformed the way banking was done. It has prompted the large scale banking corporation to step in, as the application of modern technology requires more resources. Mergers are already producing in Western countries mega banking and financial establishments. Globalization of financial markets has led to more and more integration of capital markets. Liberalization of foreign exchange markets has further reinforced this trend. The paper currency is being replaced with plastic cards and electronic records have replaced accounts books. The communication revolution through faxes, telexes, emails, have reduced the cost of international communication. Now, the saving of one country can be invested in other countries by the click of a mouse. Customers in many countries can now "navigate" on the internet between competing banks, unit trusts, mutual funds and even business firms.

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[28] International Monetary Fund, *World Economic Outlook,* May 1997, p.45

What all this means for Islamic banking? Shall it help Islamic banks or harm them? It may be difficult to venture out a definite answer to these questions but it may not be too adventurous to put on record some initial conjectures:

a. Islamic banks are too small to benefit from, or even participate effectively in the process of globalization. They cannot play any significant role because of their small size. This reinforces our earlier suggestion that they should consider mergers or at least establish joint ventures.
b. Under the right conditions, internationalization of financial markets can benefit Islamic banking. Most importantly, Islamic countries need to improve their investment climate, develop their financial markets and reform their economies. This would enable Islamic financial institutions to channel domestic as well as foreign savings into Muslim countries to meet the great demand for such resources in those countries.

SECTION 5
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Twenty-five years ago Islamic banking was considered a wishful thinking. However, serious research work of the past two and half decades has shown that Islamic banking is a feasible and viable way of financial intermediation. A number of Islamic banks have also been established during this period under heterogeneous social and economic milieu. The successful operation of these institutions and the countrywide experiences in Pakistan, Iran, Sudan and partly in Malaysia are sufficient to show that Islamic banking offers an alternative method of commercial banking.

The commendable achievements during the last twenty years should not lead us to ignore the problems that Islamic banking is facing, and there is no dearth of those. While many problems are a result of the inappropriate environment in which Islamic banks are working, there are others which have arisen from the practices of Islamic banks themselves.

5.1 Taking Stock of Islamic Banking Practices

Islamic banks have succeeded in mobilizing large amount of funds. While the estimates about the exact magnitude of the Islamic banking market vary, it can be safely assumed that it presently exceeds 100 billion US dollars excluding country-wide experiences, and is poised for growing further in future. The fact that many conventional banks, including some major multinational Western banks have also started using Islamic banking techniques provides an additional support to the viability of Islamic banking.

The available data shows that Islamic banks are rather small in size. In terms of the size of capital, economic literature has determined that for banks under US dollars1 billion, the optimum size (where average cost is minimum) is between US dollars 75-300 million. There are only eight Islamic institutions, which can be considered to have reached the optimum size in terms of capital.

The rate of return on assets for Islamic banks is comparable to the corresponding rates for the commercial banks. However, it should be noted that while the deposits of conventional banks are guaranteed, this is not the case with Islamic banks. Therefore, depositors would expect that the rate of return for Islamic banks is higher than their conventional counterparts to compensate for the risk taken by them. The current rates of profits on assets of the Islamic banks may not be enough to meet that expectation. Nevertheless, in a comparative framework, the performance of Islamic banks is not bad.

The capital asset ratio for Islamic banks as a group is well above international standards fixed by Basle Committee, although there are significant variations within Islamic banks.

The average rate of return on capital for Islamic banks also compares quite favorably with the conventional banks. In addition to a better rate of return on capital, if one considers the fact that the capital asset/ratio of Islamic banks is higher than their counterparts, one can easily conclude that Islamic banking as a business is doing reasonably well.

As far as the use of various modes of finance is concerned, *murabahah* accounts for 70 percent of total financing. *Ijara* accounts for another 5 percent. Thus the fixed-return modes account for 75 percent of total financing. The unspecified "Others" category takes another 11 percent. The profit-sharing modes account for less than 14 percent of financing.

In case of financing by sectors, trading gets the biggest proportion of financing, i.e., 42 percent. The second largest sector is real estate which accounts for 13 percent. Agriculture claims only 2 percent and industry 12 percent of the financing. One reason for this pattern is again the dominance of *murabahah* as a mode of finance. *Murabahah*, as is well known, is

basically a trading technique. It has not lost that character when it was turned into a financial instrument. Another reason is that the countries in which major Islamic banks are situated (i.e., G.C.C countries), do not have strong industrial and/or agricultural sectors.

5.2 Major Challenges Facing Islamic Banking

5.2.1 Building Proper Institutional Framework

Every system has its institutional requirements. Islamic banks alone cannot cater for all of their institutional requirements which is supposed to provide alternative ways and means for meeting the needs of venture capital, consumer finance, short term capital, long term capital, etc. A number of mutually supporting institutions/arrangements are needed to perform various functions. These include security markets, investment banks and equity institutions such as mutual funds, pension plans etc. Even within the commercial banking arena, a number of supporting institutional arrangements, such as lender of the last resort, insurance and re-insurance facilities, inter-bank markets, etc. need to be established.

Building a proper institutional set-up is perhaps the most serious challenge for Islamic finance. To face this challenge, a "functional approach" towards building this set-up should be adopted. The functions being performed by various institutions in the conventional framework should be examined and attempts should be made to establish institutions that can perform those functions in an Islamic way.

5.2.2 Increased Competition

Islamic banks have succeeded in mobilizing large amount of funds. However, it will require much more strenuous efforts to maintain a reasonable rate of growth in future. There are several reasons for that. Firstly, it must be realized that much of the deposits now with the Islamic banks came not due to the attraction of higher returns or better services but because of religious commitment of the clients. Many of them were keeping their savings in conventional banks without taking any interest on them and many others were keeping them in private safes. For all such persons, a modest return or even no return from Islamic banks, was acceptable. Most

of this money has already found its way into the coffers of Islamic banks. Therefore, this source has been almost dried up. Secondly, so far Islamic banks had a fairly large degree of 'monopoly' over the financial resources of Islamically motivated public. This situation is changing fast. Islamic banks are now facing ever-increasing competition. An important development in Islamic banking in the last few years has been the entry of some conventional banks including some major multinational Western banks in that market.

This development is a clear recognition of the viability of Islamic banking as an alternative model but at the same time, it has increased competition. Does it augur well for the future of Islamic banking? The answer will depend on how the Islamic banks react to this development. In general, competition is supposed to be good for the growth of any industry. It forces inefficient firms to either shape up or shape out. It reduces the costs and improves services to consumers. It promotes innovation and brings improvements in product quality.

The conventional banks, particularly the western banks have a large advantage over Islamic banks in terms of their size, experience, market coverage and long standing in the industry. This exposes the Islamic banks to an intense competition. Therefore, the survival of Islamic banks depends on their ability to increase efficiency and performance.

5.2.3 Building Bridges and Strategic Alliances

The competition from conventional banks is expected to increase further in near future due to globalization. The world markets are rapidly converging into a single market place. Liberalization of foreign exchange markets has further reinforced this trend. Technological innovations are also playing an important part in financial integration and globalization. The communication revolution through electronic correspondence has reduced the cost of international communication. Customers in many countries can "navigate" on the Internet between competing banks, unit trusts, mutual funds and even business firms.

Islamic banks cannot remain aloof of these developments. They must carefully watch these developments and adjust their strategies accordingly. In order to operate in global markets, they have to increase the

size of their operations as well as form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested to do banking on Islamic principles. Such strategic alliances will benefit both sides.

5.2.4 Need to Increase the Size of Islamic Banks

Size is an important variable to determine the efficiency of a bank. It determines the scale and scope efficiencies. Economists have shown that larger banks are in a better position to reach the optimum mix and scale of output. As a result, they are more efficient than smaller ones. The available data shows that Islamic banks and financial institutions are much below the optimum size. In addition to efficiency, there are some other reasons also to advocate larger size. A large capital base is one of the important factors influencing positive credit rating. It reflects shareholders' commitment to their business. That comes handy in case a bank wants to raise additional capital. The small size of Islamic banks is also a major factor for lack of portfolio diversification. Resources at their disposal are not sufficiently large to minimize risk through portfolio diversification. In order to increase the level of efficiency and deal more effectively with financial markets, it is desirable that the size of operations of Islamic banks be substantially increased. In this regard, serious consideration should be given to mergers.

5.2.5 Financial Engineering

Financial markets are becoming more and more sophisticated, and competitive. In order to exploit the fast changing market environment and face increasing competition, financial engineering and innovation is imperative.

Until now, the Islamic financial tools have essentially been limited to classical instruments developed centuries ago and their variants. Those instruments were developed to meet the needs of those societies. While they may serve as useful guidelines for Islamic contracts, there is no reason to be restricted only to them.

In the light of the principles of *ijtehad*, a "needs approach" to financial engineering is desirable, of course within the known principles of Islamic finance. Engineers in modern finance have designed several new

instruments such as mortgage, options, derivatives, hedging, insurance pension plans, credit cards etc. to meet the needs of customers for various financial services. We must examine what needs are being fulfilled by these instruments. If the needs are genuine (Islamically speaking), then we must either adapt them for our purposes or invent Islamic alternatives for them.

5.2.6 Shari'ah Aspects

Because of the religious dimension of Islamic banking and finance, no new product can be adopted until it is cleared by *shari'ah* scholars. Even after a new product is put into use, *shari'ah* auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of *shari'ah*. This is important not only for religious reasons but also for purely business considerations because the clients of Islamic banks will not have confidence in their operations unless *shari'ah* scholars clear their activities. In this background, the expertise of *fiqh* scholars in understanding the pre-requisites of modern financial products and in evaluating these products becomes very important.

Almost all Islamic banks have their own *shari'ah* boards or *shari'ah* advisers. The past record shows that *shari'ah* bodies have done a commendable job in evaluating the applications of traditional contracts and safeguarding against the use of some and the misuse of others. However, when it comes to evaluating modern financial contracts or Islamic substitutes for them, *shari'ah* bodies have found it quite difficult to issue verdicts. This is basically due to an acute shortage of scholars with dual specialization or at least working knowledge of modern finance and *shari'ah* at the same time. There is an urgent need to increase the supply of scholars with dual specialization.

5.2.7 Teaching, Training, Research and Development

Teaching, training and research are the where-with-all for the development of any discipline. This is more so for a discipline like Islamic banking and finance, which is still nascent. As mentioned above, there is a serious shortage of scholars who possess even a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly, most of the Managers of Islamic banks are not very well trained in the use of Islamic modes of finance. An institution is what its employees make it. Therefore, it

is extremely important to have the people with the right kind of skills and commitment to run the Islamic banks.

Another very important component for useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. There is no consistent data series on the activities of Islamic banks for a reasonable number of years available anywhere. Whatever little information is available, is also subject to a number of qualifications.

Unfortunately, very little effort has been made to meet these requirements. Neither the Islamic banks as a group nor any of the individual Islamic banks spend any sizeable amount on research and development. There is a need to increase efforts in this area to several times the current levels.

5.2.8 Fixed versus Variable Return Modes of Finance

Islamic financial system has presented a number of financial instruments. Broadly speaking, they may be classified into fixed-return and variable return or profit sharing modes. Each of these categories has its merits and demerits. In practice, however, the use of profit-sharing modes in Islamic banking has been very limited. There are many reasons due to which businessmen do not prefer PLS contracts. These include among others:

a. need to keep and reveal detailed records,
b. it is difficult to expand a business financed through *mudarabah* because of limited opportunities to re-invest retained earnings and/or raising additional funds,
c. the entrepreneur cannot become the sole owner of the project except through diminishing *musharakah*, which may take a long time. Similarly, there are some practical reasons for banks to prefer fixed-return modes. These include:
   - due to moral hazard and adverse selection problems in all agent-principal contracts, e.g., *mudarabah*, there is need for closer monitoring of the project. This requires project monitoring staff and mechanisms, which increase the costs of these contracts,

- On the liabilities side, the structure of deposits of Islamic banks is not sufficiently long-term. Therefore, they do not want to get involved in long term projects, and
- PLS contracts require a lot of information about the entrepreneurial abilities of the customer. This may not be easily available to the bank.

On the other hand, there are several reasons why the fixed-return modes have become more popular in practice. They have a number of desirable features such as simplicity, convenience and safety. They are providing banks high liquidity with low risk. Under present circumstances, the use of tools like *murabahah* by Islamic banks is indispensable. Until proper institutional set-up is built and needed products, including those for managing risk, are developed, it may not be advisable to drastically increase the use of risky modes. However, several problems have been noted in the way these are being used. Serious attempts should be made to "cleanse" the "quasi" *murabahah* being practiced by some Islamic banks at present to make it "genuine" *murabahah*.

It may be noted that the fixed-return modes of finance being used by Islamic banks are clearly distinguishable from interest-based modes. Transactions of the former modes are always done through real transactions, while in the latter they are carried through inter-temporal exchanges of money. It may also be noted that if these modes are used properly, then some risk sharing is involved.

However, in order to have a more diversified portfolio, it would be desirable that the predominance of fixed return modes such as *murabahah* and leasing on the asset side is gradually reduced over the long run.

5.2.9 Need For Establishing Equity Institutions

In all businesses there is need for long term finance. In conventional system, this is provided through long term bonds and equities. Securities markets and specialized equity institutions perform this function. In addition to the general public, the most important sources of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. If transformation into a more equity-based financial system is to take place, steps should be taken to encourage business corporations to

increase their reliance on equity and decrease their dependence on debt. For this to happen, however, more equity institutions need to be established. In view of the importance of long term risk capital for economic growth, establishment of institutions providing equity capital is very important for the survival and success of Islamic finance.

It may be mentioned here that even in conventional finance, there is an increasing trend towards use of equities as a source of business finance. Savers are now increasingly recognizing the benefits of profit-based instruments. The appeal of rate-based investment is waning. Although stock market investments have not become any less risky over the years, savers are beginning to accept the historical evidence that in any five year period since World War II, with one exception, stocks have produced higher returns than bank accounts, bonds or bullion. There is now a world wide trend for establishing equity institutions such as mutual funds. Islamic financial markets have to take note of recent developments in international financial markets.

The situation is also ripe for establishing equity-based institutions and instruments. There is an historic opportunity of taking advantage of privatization programs going on in many Muslim countries. A number of public companies, many with good track records and bright prospects are being offered to private parties. Islamic banks and financial institutions can take advantage of this opportunity. It must be noted, however, that leading *shari'ah* institutions have ruled that it is not permissible to take equity stake in companies which deal in interest even in small proportions. While this rightly reflects the serious concern that Muslims must garner against the use of interest, this puts a serious constraint on placement of funds. It closes an important market to Islamic banks and also exposes many big corporations in Muslim countries to foreign ownership. The matter needs serious consideration with a view to find an acceptable solution on the basis of a common need.

5.2.10 Appropriate Legal Framework, Policies and Procedures

The commercial, banking and company laws in most of the Islamic countries are fashioned on the Western pattern. Those laws provide a rather narrow scope for Islamic banking activities. While parties can structure their

agreements according to an Islamic contract, the enforcement of those agreements can be costly. Those conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. It is necessary to enact some laws to facilitate the operation of a mixed system. In this respect, one important policy issue is the treatment of dividends for the purposes of determining tax liability. Under the conventional system, interest paid by corporations is treated as a tax-deductible expense. Similar treatment must be given to the dividends paid out by financial institutions.

5.2.11 Supervisory Framework

Supervision of Islamic banks is as important as that of the conventional banks. To protect the interests of the public and the economy from financial panics, most governments have created elaborate regulatory bodies. In most countries Islamic banks are put under the supervision of the central bank of the country. Most of Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with the Islamic banks. The central banks subject the Islamic banks to the same controls, conditions and regulations that they apply to the interest based banks. However, there are certain factors, which require that Islamic banks should be treated on a different footing. Some of these factors are the following:

a. Islamic banks, like all other commercial banks are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic banks cannot accept. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central banks.

b. Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most of Islamic banks function under the supervision of central bank, they cannot always benefit from such a facility because, funds are usually provided on the basis of interest. Some alternative ways for providing such help to Islamic banks have been suggested but have not found favor in practice.

c. Legal reserves imposed on deposits with conventional banks. Their rates vary between demand, saving and time deposits. These requirements may apply to the same extent only in case of Islamic banks' demand deposits. The *mudarabah* deposits of Islamic banks are similar to banks' equity. Therefore, they should be exempted from legal reserve requirements.

d. In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of interest-based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.

e. Lack of understanding the correct nature of Islamic financing techniques may also be partially responsible for rather inappropriate policies of the central banks towards Islamic banks. This is particularly true of *musharakah* and *mudarabah*. In debt financing, granting of a loan by a bank is a one-time activity, no matter what is the size of the loan. But *musharakah* and *mudarabah* are ongoing activities and participation of an Islamic bank in these activities continues as long as the project financed is in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks.

5.3 Recommendations

In order to operate in global markets effectively, it is desirable that the size of operations of Islamic banks be substantially increased. In this regard, serious consideration should be given to mergers. Islamic banks have to increase their size as well as form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested to do banking on Islamic principles.

To promote teaching, training and research in Islamic banking and finance and to produce and disseminate authentic information on their

activities with a view to develop new Islamic financial products, it is proposed that Islamic banks strengthen their cooperation with the assistance of the Islamic Research and Training Institute.

With a view to broaden the equity base of the economies of Muslim countries, it is desirable to establish institutions dealing more in equities. These include mutual funds, unit trusts, pension plans etc. It would also be desirable to encourage businesses through macro-economic policies to increase the use of equity finance and decrease their reliance on debt.

Until Islamic countries do not opt for a complete Islamic banking system, it is necessary to enact some laws to facilitate the operation of a mixed system. In this context, one of the most serious problems being faced by Islamic banks is the lack of proper legal framework to deal with cases of delayed payments and bad loans expeditiously. Since Islamic banks cannot charge interest on the delayed debts, they face a bigger risk of default as well as loss in income. These considerations, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place.

Another important policy issue relates to tax treatment. Under the conventional system, interest paid by corporations is treated as a tax-deductible expense. Similar treatment must be given to the dividends paid out by financial institutions.

It is proposed that an autonomous Board for *shari'ah* supervision of Islamic banks, may be constituted. In addition, there is also a need for Central banks in Muslim countries to consider the special nature of Islamic banking and devise suitable international standards for major control variables similar to the Basle Committee for Banking Supervision.

There is an urgent need to increase the supply of scholars with dual specialisation in *shari'ah* and finance. In order to meet this need, it is recommended that courses may be introduced for *shari'ah* scholars in economics and finance. Similarly, courses in *shari'ah* especially designed for economists and financial experts may be initiated

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Annexures

Annexure I

CHALLENGES FACING ISLAMIC BANKING: PERCEPTION OF SCHOLARS

In order to identify the most important challenges facing Islamic banking, a detailed questionnaire was distributed among scholars working in the area. The questionnaire contained explanatory notes on the issues on which the perception of the scholars was being sought.

The response from the scholars was very good. IRTI is grateful to the scholars who participated in the study by allocating their precious time for filling the questionnaire. The responses to 30 different issues raised in the questionnaire are summarized in the attached table in the order of importance attached to them by the respondents. In addition, to these specific issues, some respondents mentioned some other challenges facing Islamic banking. These valuable comments and observations have been utilized separately and are not included in the table.

It can be seen that lack of financial engineering, illiquidity of assets (due to lack of negotiable instruments), implication of globalization, lack of profit sharing on assets side and lack of mechanism to deal with defaulters of debt are perceived to be the five most important challenges facing Islamic banking in general. All of these issues have been discussed in the paper.

CHALLENGES FACING ISLAMIC BANKING: PERCEPTION OF SCHOLARS

Challenges	Not a Problem		Mild problem for some Islamic banks		Serious problem for some Islamic banks		Mild problems for Islamic banking in general		Serious problems for Islamic banking in general		Total
	Count	%	Count	%	Count	%	Count	%	Count	%	%
1. Lack of financial engineering	4	6.67	3	5.00	7	11.67	9	15.00	37	61.67	100
2. Illiquidity of asset structure	2	3.45	6	10.34	5	8.62	10	17.24	35	60.34	100
3. Implications of globalization for Islamic banking	5	8.62	5	8.62	2	3.45	15	25.86	31	53.45	100
4. Lack of profit sharing on asset side	7	11.86	1	1.69	9	15.25	12	20.34	30	50.85	100
5. Lack of mechanism to deal with loan defaulters	1	1.67	4	6.67	10	16.67	17	28.33	28	46.67	100
6. Short-term asset structure	3	5.17	5	8.62	5	8.62	18	31.03	27	46.55	100
7. Lack of opportunities for short-term placement of funds	3	5.08	7	11.86	7	11.86	18	30.51	24	40.68	100
8. Lack of lender of last resort	7	11.86	7	11.86	8	13.56	13	22.03	24	40.68	100
9. Lack of risk management tools	4	6.90	5	8.62	6	10.34	22	37.93	21	36.21	100
10. Lack of cooperation among Islamic banks	7	12.07	8	13.79	8	13.79	14	24.14	21	36.21	100
11. Lack of supporting institutions such as insurance etc.	2	3.45	8	13.79	8	13.79	20	34.48	20	34.48	100
12. Moral hazard	4	6.78	7	11.86	11	18.64	18	30.51	19	32.20	100
13. Lack of projects appraisal machinery & mechanism	4	6.78	5	8.47	18	30.51	13	22.03	19	32.20	100
14. Lack of ability of *shari'ah* auditors in modern finance	4	7.02	10	17.54	4	7.02	21	36.84	18	31.58	100
15. Narrow ownership base	9	15.52	5	8.62	14	24.14	12	20.69	18	31.03	100
16. Unfair treatment in taxation	5	8.47	13	22.03	10	16.95	13	22.03	18	30.51	100
17. Adverse selection	9	15.52	9	15.52	9	15.52	14	24.14	17	29.31	100

18. Excess liquidity with Islamic Banks	6	10.17	4	6.78	12	20.34	21	35.59	16	27.12	100
19. Existence of competitors of different nature	16	27.59	6	10.34	7	12.07	14	24.14	15	25.86	100
20. Dominance of debt in asset structure	9	15.52	9	15.52	10	17.24	16	27.59	14	24.14	100
21. Lack of uniform accounting practices	11	18.97	4	6.90	5	8.62	24	41.38	14	24.14	100
22. Lack of transparency in p/s ratios among capital providers	7	12.07	10	17.24	11	18.97	16	27.59	14	24.14	100
23. Inability to meet financial needs of clients for different types of funds	8	13.79	7	12.07	15	25.86	14	24.14	14	24.14	100
24. Difficulties for Islamic banks to operate in non-Muslim countries	7	12.07	8	13.79	12	20.69	17	29.31	14	24.14	100
25. Lack of portfolio diversification	5	8.47	8	13.56	16	27.12	16	27.12	14	23.73	100
26. Lack of supervision by central banks	12	20.69	11	18.97	14	24.14	11	18.97	10	17.24	100
27. Lack of confidence of clients due to non-existence of deposit insurance	13	22.81	9	15.79	8	14.04	19	33.33	8	14.04	100
28. *Shari'ah* objections In issuing LGS/LCS	10	17.24	7	12.07	10	17.24	23	39.66	8	13.79	100
29. Lack of use of modern technology in banking in banking and finance	7	11.86	7	11.86	16	27.12	21	35.59	8	13.56	100
30. Non-existence of branch banking	10	16.95	8	13.56	17	28.81	17	28.81	7	11.86	100

Annexure II

SOURCES AND QUALITY OF DATA

The availability of information and relevant statistical data is a precondition for carrying out empirical and analytical studies in any area. It also plays a significant role in product development. Empirical research on Islamic banking is seriously hampered by the non-availability of required and relevant statistical data. It will be some time before scientifically collected, reliable data on Islamic banking becomes readily available to researchers. Present availability of statistical data on Islamic banking and its quality leaves a lot to be desired.

Main sources of published statistical data on the Islamic banks in the corporate sector are the following:

- i Annual Reports of Islamic Banks
- ii Directory of Islamic Banks published by International Association of Islamic Banks
- iii The Harvard Islamic Finance Information Program (HIFIP Database)
- iv The Bankers' Almanac

Annual Reports of Islamic banks are the main source of data. These reports contain two financial statements: balance sheet of the bank and its profit and loss statement. In addition to these statements, the annual reports also have a limited amount of statistical information that is given in various explanatory notes attached to these statements. All secondary data on Islamic banking, compiled by other agencies such as International Association of Islamic Banks, or HIFIP (Harvard Islamic Finance Information Project), are mainly derived from the annual reports of Islamic banks for different years. However, there are a number of variables on which no statistical information is available even in these reports. For example, if some researcher is interested in finding out the Size distribution of deposits in order to determine whether Islamic banks attract small depositors or not, he will not be able to do so, as relevant statistical information is not readily available.

There are a number of difficulties in using the data reported in the annual reports for analytical purposes. These include:

i The accounting practices amongst the Islamic banks are highly dissimilar. It may be noted that existing Islamic banks have to function under different types of social environments and heterogeneous economic milieu. They have to put up with different types of official requirements regarding accounting practices. This results in dissimilarity of accounting practices among different Islamic banks to the extent that any meaningful comparison between the balance sheets or profit-and-loss accounts of two different Islamic banks becomes a very difficult task if not altogether impossible.

ii The concepts used in the balance sheets or in the profit-and-loss statements are not rigorously defined and differ from one bank to another. It was to bring standardization in recognition and reporting of accounting concepts that an organization of Accounting Standards for Islamic Financial Institutions was established in Bahrain. However it appears that the work of this institution has not brought yet the needed harmonization and standardization in statistical data on Islamic banking.

iii It appears that various entries in the financial statements and accounting practices change within a given Islamic banks over time. This leaves the financial statements of an Islamic bank incomparable with its statements of previous years.

iv The level of detail differs from report to report within a single bank. For instance, the Annual Report of a Bank for the year 1991 classified total deposits into four categories and reported figures for each of them separately. However, the 1992 report of the same bank classifies total deposits only in two categories.

v The financial year differs from one Islamic bank to another. Some Islamic banks have *Hijrah* year while some other still follow Gregorian calendar.

Whatever empirical analysis could be done on the basis of information derived from the annual reports is further hampered by the fact that even

these reports are not available easily. It is a sad reflection on the state of availability of statistics on Islamic banking that even premier institutions of Islamic banking do not possess a complete set of annual reports of Islamic banks.

Many Islamic Banks were established in the late seventies and early eighties. Some of these institutions have completed 20 years of their existence. It would be useful to evaluate historical experience of these institutions. Unfortunately, no time series is available anywhere for this purpose, even on those variables, on which statistical information is commonly available in the Annual Reports of Islamic banks.

Recently, the International Association of Islamic banks has taken on itself the task of publishing comparable data on Islamic banking. Although the Association has been making a commendable effort which deserves to be supported and strengthened, the data collected by the Association suffers from certain shortcomings originating from the primary data:

- i The Association writes to central banks of all countries in order to obtain the list of Islamic financial institutions. It is suspected that it may include certain banks and financial institutions as Islamic banks which may not be so in the exact sense of the term.
- ii The data are collected by sending a questionnaire to Islamic banks. There are many gaps in the data as banks do not report the figures on many variables such as decomposition of financial operations etc.
- iii Data on sectoral financing and modes of financing is reported only through percentage distribution. This reduces the usability of the data.
- iv Preparation and publication of comparable data has not been regular except from the year 1993.

The HIFIP database is available on a CD-ROM. Since it is based on the information obtained from the Annual Reports of the Islamic banks, it suffers from all the shortcomings and drawbacks noted above in case of

Annual reports of Islamic banks. Some errors in data entry have also been noticed which has reduced the reliability and authenticity of the database.

The Bankers' Almanac also gives statistical data on some Islamic banks but the number of such banks is limited. Moreover, it gives data for some main variables only such as capital, total deposits, reserves, assets, and some selected items from the Profit Loss Account. As such the data contained in the Almanac is of limited use only.

Suggestions for Improvement

The statistical problems discussed above may not be solved in the short run. However, the availability of scientifically collected, accurate and reliable statistics can go a long way to improve the quality and quantity of research on Islamic banking and finance. It may also facilitate research and development activity at the Islamic banks. It would require considerable effort before the situation can improve. At this point the following suggestions may be made in order to encourage constructive thinking on this subject:

i An international seminar on the subject, "Statistical Problems of Islamic Banking". may be organized. Statisticians, economic researchers, economists and Islamic bankers may be asked to examine various dimensions of the issue and suggest possible solutions.

ii Consideration may be given to launching a project on preparation of long-term Islamic Banking statistics. This may be titled, ISLAMIC BANKING STATISTICS 1980 –2000. The project shall aim at preparing detailed, comparable and consistent financial statements of at least 25 major Islamic banks and must be run under the supervision of economists.

iii IRTI and IDB library may jointly launch a project to collect and store all the Annual Reports of all Islamic banks. The merit of this project shall lie in its wide coverage and comprehensiveness. Later on all the annual reports of Islamic banks may be put on a CD-ROM.

Statistical Annexure

Key Financial Indicators 1994-96

(Thousand US Dollars)

Name of Bank	**Year**	***Capital***	***Assets***	***Deposits***	***Reserves***	***Profit***	***Cap/Asst***	***Res/Dep***	***ROA***	***ROE***
Albaraka Islamic Invest.Bank	1994	50000	160,135	91,762	3732	8100	31.22	4.07	5.06	16.20
	1995	50000	156,800	87,276	4132	10807	31.89	4.73	6.89	21.61
	1996	50000	155,638	84,799	3543	11205	32.13	4.18	7.20	22.41
	1994-96	50000	157,524	87,946	3802	10037	31.75	4.33	6.38	20.07
Bahrain Islamic Bank	1994	30667	349,352	306,723	4496	12693	8.78	1.47	3.63	41.39
	1995	30667	379,507	335,053	5155	17827	8.08	1.54	4.70	58.13
	1996	30585	376,588	331,465	5902	19128	8.12	1.78	5.08	62.54
	1994-96	30640	368,482	324,414	5184	16549	8.33	1.59	4.47	54.02
Faysal Islamic Bank of Bah.	1994	70000	1,958,900	1,288,900	22900	16100	3.57	1.78	0.82	23.00
	1995	70000	1,791,700	1,274,600	30800	16100	3.91	2.42	0.90	23.00
	1996	100000	2,109,800	1,331,200	16300	18200	4.74	1.22	0.86	18.20
	1994-96	80000	1,953,467	1,298,233	23333	16800	4.07	1.81	0.86	21.40
Islami Bank Bangladesh Ltd	1994	4472	516,993	285,830	8496	6233	0.87	2.97	1.21	139.38
	1995	4472	642,538	354,080	14952	8720	0.70	4.22	1.36	194.99
	1996	8804	635,718	392,035	21213	7909	1.38	5.41	1.24	89.83
Dubai Islamic Bank	1994	68462	1,492,000	1,372,950	9837	57404	4.59	0.72	3.85	83.85
	1995	91484	1,680,683	1,521,179	10940	76850	5.44	0.72	4.57	84.00
	1996	114440	1,937,110	1,736,325	12475	90665	5.91	0.72	4.68	79.22
	1994-96	91462	1,703,264	1,543,485	11084	74973	5.31	0.72	4.37	82.36

Faisal Islamic Bank of Egypt	1994	100000	1,659,000	1,332,000	9421	59536	6.03	0.71	3.59	59.54
	1995	100000	1,820,606	1,442,474	9917	88729	5.49	0.69	4.87	88.73
	1996	100000	1,970,786	1,564,621	10404	97581	5.07	0.66	4.95	97.58
	1994-96	100000	1,816,797	1,446,365	9914	81949	5.53	0.69	4.47	81.95
Jordan Islamic Bank	1994	20837	814,296	660,220	34000	10440	2.56	5.15	1.28	50.10
	1995	20602	878,410	718,196	38636	10263	2.35	5.38	1.17	49.82
	1996	20573	872,574	708,465	38452	10023	2.36	5.43	1.15	48.72
	1994-96	20671	855,093	695,627	37029	10242	2.42	5.32	1.20	49.55
Kuwait Finance House	1994	141000	4,270,000	3,600,000	86000	99317	3.30	2.39	2.33	70.44
	1995	150977	4,682,168	3,770,849	140161	105463	3.22	3.72	2.25	69.85
	1996	158967	4,732,017	3,766,707	199190	114547	3.36	5.29	2.42	72.06
	1994-96	150315	4,561,395	3,712,519	141784	106442	3.30	3.80	2.33	70.78
Bank Islam Malaysia Berhad	1994	52351	1,156,389	999,136	36922	12547	4.53	3.70	1.09	23.97
	1995	52501	1,278,364	1,127,887	39922	16724	4.11	3.54	1.31	31.85
	1996	52708	1,426,452	1,262,853	48875	14898	3.70	3.87	1.04	28.27
	1994-96	52520	1,287,068	1,129,959	41906	14723	4.11	3.70	1.15	28.03
Qatar Islamic Bank	1994	41220	876,727	669,542	22637	32149	4.70	3.38	3.67	77.99
	1995	41220	778,039	659,400	23006	27586	5.30	3.49	3.55	66.92
	1996	40883	827,276	693,619	4816	30656	4.94	0.69	3.71	74.98
	1994-96	41108	827,347	674,187	16820	30130	4.98	2.52	3.64	73.30
Total (1994+95+96)		1867892	42386566	33770146	917232	1108400	4.41	2.72	2.61	59.34
Total of 3-Year Ave (1994-96)		622631	14128855	11256715	305744	369467	4.41	2.72	2.61	59.34

Source: Directories of Islamic Banks and Financial Institutions, International association of Islamic Banks, Jeddah.

Top Ten Islamic Banks (1996)

(Millions US Dollars)

Banks	Tier 1 Capital*	Total Assets*	Cap/Asst Ratio	Net Profit*	Profit/Cap Ratio	Profit/Asst Ratio
Al-Rajhi Banking & Invest Corp.	1269	8608	14.74	322.13	25.38	3.74
Kuwait Finance House	368	4732	7.77	114.546	31.15	2.42
Faysal Islamic Bank of Bahrain E.C.	116	2110	5.51	23.13	19.88	1.10
Dubai Islamic Bank	155	1935	8.03	15.36	9.88	0.79
Faisal Islamic Bank of Egypt	122	1971	6.19	0	0.00	0.00
Bank Islam Malaysia Berhad	110	1549	7.13	21.7	19.65	1.40
Jordan Islamic Bank for Fin. & Invest.	62	871	7.08	7.9	12.81	0.91
Qatar Islamic Bank	59	812	7.27	9.32	15.80	1.15
Islamic Int'l Bank for Invest. & Dev.	66	723	9.11	10.31	15.64	1.42
Albaraka Turkish Finance House	11	566	1.91	7.32	67.78	1.29
Total	2338	23878	9.79	531.72	22.74	2.23
AVERAGE	233.82	2387.83	7.47	53.17	21.80	1.42

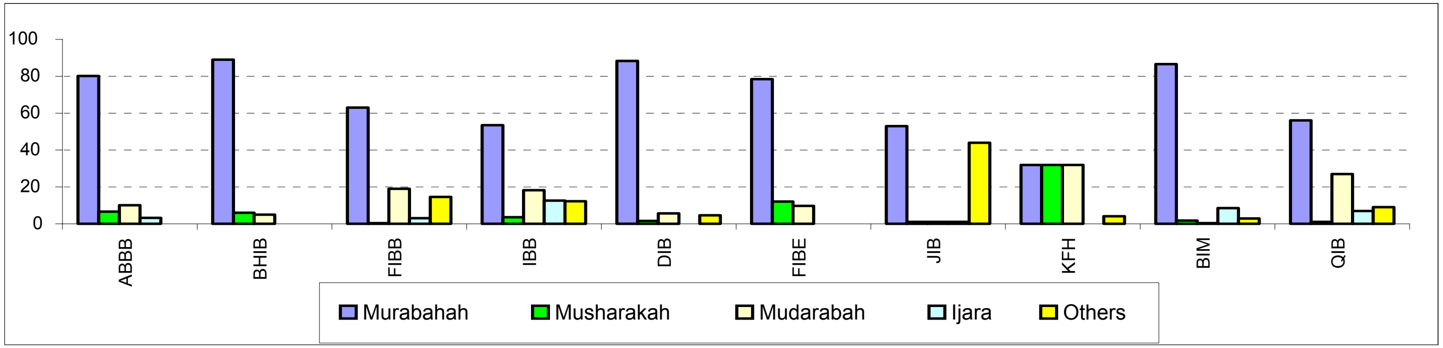
Source: Annual Reports

Financing by Modes 1994

Banks	*Murabahah*	*Musharakah*	**Mudarabah**	*Ijara*	*Others*
ABBB	80.1	6.6	10.0	3.3	0.0
BHIB	89.0	6.0	5.0	0.0	0.0
FIBB	63.0	0.4	19.0	3.0	14.6
IBB	53.4	3.5	18.2	12.6	12.3
DIB	88.3	1.5	5.6	0.0	4.6
FIBE	78.4	12.0	9.6	0.0	0.0
JIB	53.0	1.0	1.0	1.0	44.0
KFH	32.0	32.0	32.0	0.0	4.0
BIM	86.6	1.7	0.3	8.5	2.9
QIB	56.0	1.0	27.0	7.0	9.0
AVERAGE	68.0	6.6	12.8	3.5	9.1

Frequency Distributions

	Murabahah	*Musharakah*	*Mudarabah*	*Ijara*	Others
10	0	8	6	9	7
20	0	1	2	1	2
30	0	0	1	0	0
40	1	1	1	0	0
50	0	0	0	0	1
75	4	0	0	0	0
100	5	0	0	0	0

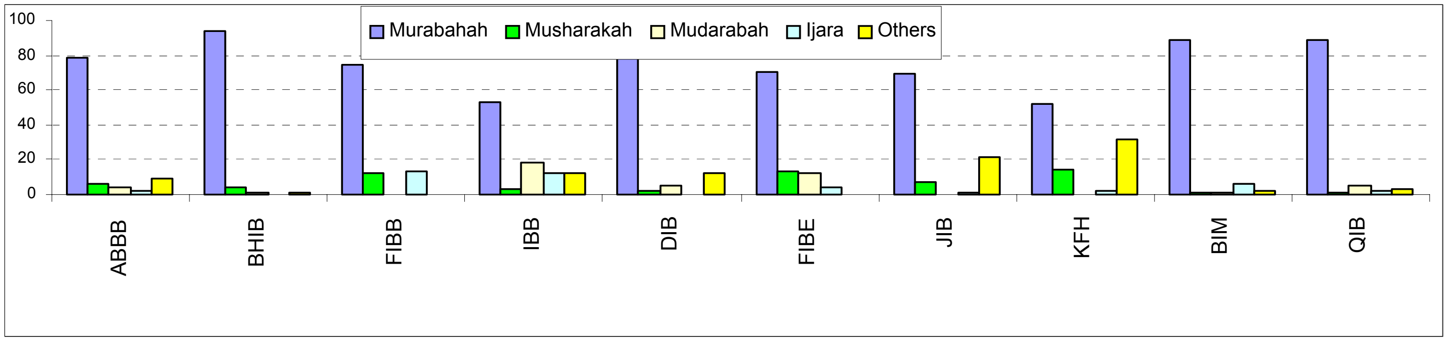


Financing by Modes 1995

Banks	Murabahah	*Musharakah*	*Mudarabah*	*Ijara*	Others
ABBB	79.0	6.0	4.0	2.0	9.0
BHIB	93.9	3.8	0.8	0.0	1.4
FIBB	74.3	12.3	0.0	13.6	0.0
IBB	53.4	3.5	18.2	12.6	12.3
DIB	81.0	2.3	4.6	0.0	12.1
FIBE	70.0	13.5	12.2	4.3	0.0
JIB	69.9	7.2	0.2	1.0	21.8
KFH	52.0	14.0	0.0	2.0	32.0
BIM	89.2	1.2	0.7	6.5	2.4
QIB	89.0	1.0	5.0	2.0	3.0
AVERAGE	75.2	6.5	4.6	4.4	9.4

Frequency Distributions

	Murabahah	*Musharakah*	*Mudarabah*	*Ijara*	*Others*
10	0	7	8	8	6
20	0	3	2	2	2
30	0	0	0	0	1
40	0	0	0	0	1
50	0	0	0	0	0
75	5	0	0	0	0
100	5	0	0	0	0

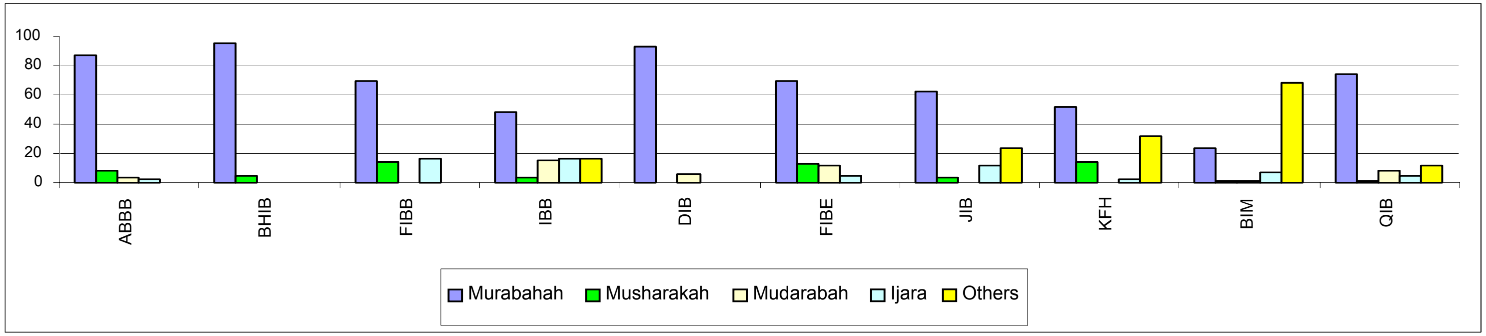


Financing by Modes 1996

Banks	*Murabahah*	*Musharakah*	*Mudarabah*	*Ijara*	**Others**
ABBB	87.00	8.00	3.00	2.00	0.00
BHIB	95.00	5.00	0.00	0.00	0.00
FIBB	69.40	14.30	0.00	16.30	0.00
IBB	48.30	3.70	14.90	17.00	16.10
DIB	93.20	0.50	6.30	0.00	0.00
FIBE	70.00	13.50	12.20	4.30	0.00
JIB	62.00	3.00	0.00	12.00	23.00
KFH	52.00	14.00	0.00	2.00	32.00
BIM	23.20	1.00	1.00	7.10	67.70
QIB	74.00	1.00	8.00	5.00	12.00
AVERAGE	67.4	6.4	4.5	6.6	15.1

Frequency Distributions

	Murabahah	*Musharakah*	*Mudarabah*	*Ijara*	*Others*
10	0	7	8	7	5
20	0	3	2	3	2
30	1	0	0	0	1
40	0	0	0	0	1
50	1	0	0	0	0
75	5	0	0	0	1
100	3	0	0	0	0

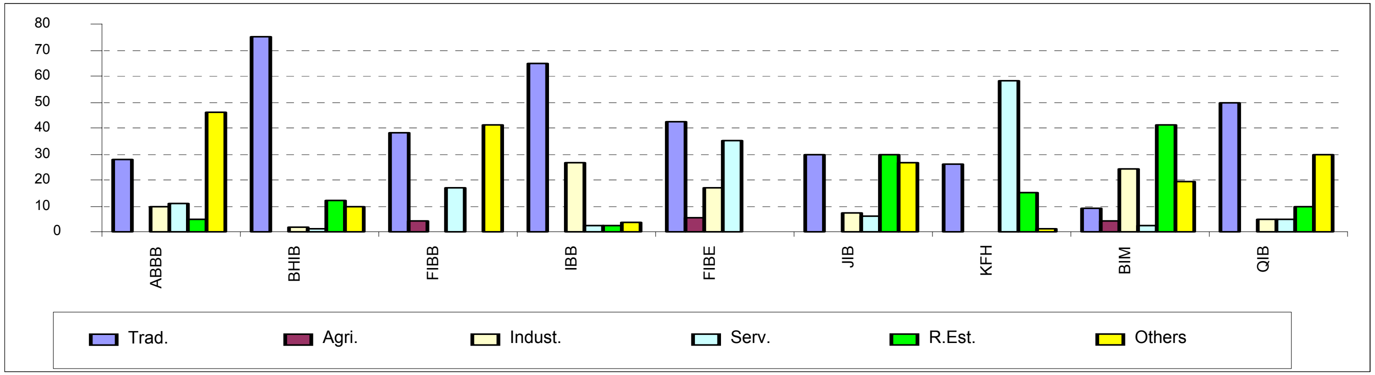


Financing by Sector 1994

Banks	Trad.	Agri.	Indust.	Serv.	R.Estat.	Others
ABBB	28	0	10	11	5	46
BHIB	75	0	2	1	12	10
FIBB	38	4	0	17	0	41
IBB	65	0	27	2	2	4
FIBE	42	6	17	35	0	0
JIB	29	0	7	6	30	27
KFH	26	0	0	58	15	1
BIM	9	4	24	3	41	19
QIB	50	0	5	5	10	30
AVERAGE	40	2	10	15	13	20

Frequency Distributions

	Trad.	Agri.	Indust.	Serv.	R.Est.	Other
10	1	9	6	5	5	4
20	0	0	1	2	2	1
30	3	0	2	0	1	2
40	1	0	0	1	0	0
50	2	0	0	0	1	2
60	0	0	0	1	0	0
80	2	0	0	0	0	0
100	0	0	0	0	0	0

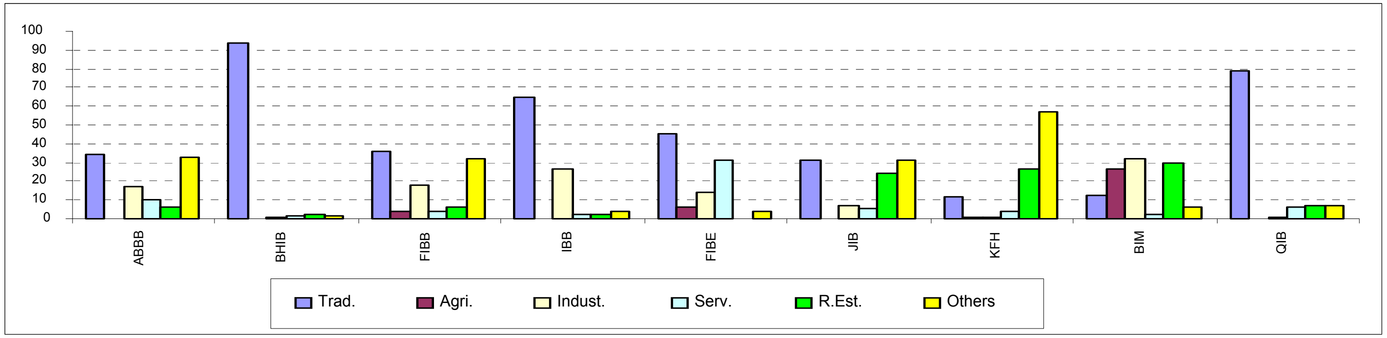


Financing by Sectors 1995

Banks	Trad.	Agri.	Indust.	Serv.	R.Est.	Others
ABBB	28.0	0.0	10.0	11.0	5.0	46.0
BHIB	93.9	0.0	0.6	1.2	2.3	1.8
FIBB	36.0	4.0	18.0	4.0	6.0	32.0
IBB	64.6	0.3	26.9	2.2	2.4	3.6
FIBE	45.0	6.0	14.0	31.0	0.0	4.0
JIB	31.2	0.3	7.4	5.6	24.5	30.9
KFH	12.0	0.5	0.9	3.7	26.2	56.7
BIM	12.6	26.8	31.8	2.7	30.0	6.1
QIB	79.0	0.0	1.0	6.0	7.0	7.0
AVERAGE	45.4	4.2	13.1	7.4	11.6	19.5

Frequency Distributions

	Trad.	Agri.	Indust.	Serv.	R.Est.	Other
10	0	8	4	8	6	5
20	2	0	3	0	0	0
30	0	1	1	0	3	0
40	3	0	1	1	0	3
50	1	0	0	0	0	0
60	0	0	0	0	0	1
80	2	0	0	0	0	0
100	1	0	0	0	0	0

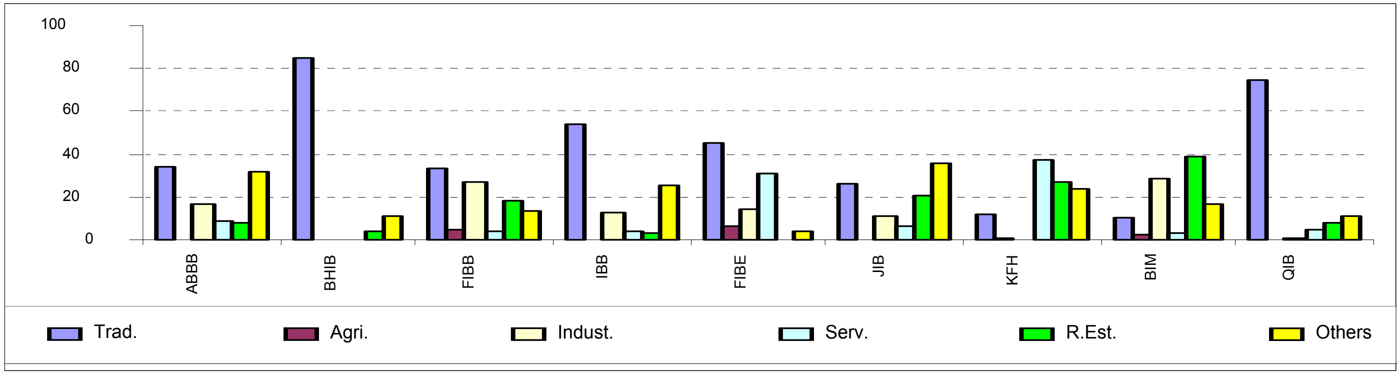


Financing by Sectors 1996

Banks	Trade	Agri.	Indust.	Service	R.Est.	Others
ABBB	34	0	17	9	8	32
BHIB	85	0	0	0	4	11
FIBB	33	4	27	4	19	13
IBB	54	0	13	4	3	26
FIBE	45	6	14	31	0	4
JIB	26	0	11	6	21	36
KFH	12	1	0	37	27	24
BIM	11	2	29	3	39	16
QIB	75	0	1	5	8	11
AVERAGE	42	2	12	11	14	19

Frequency Distributions

	Trade	Agri.	Indust.	Service	R.Est.	Others
10	0	9	3	7	5	1
20	2	0	4	0	1	4
30	1	0	2	0	2	2
40	2	0	0	2	1	2
50	1	0	0	0	0	0
60	1	0	0	0	0	0
80	1	0	0	0	0	0
100	1	0	0	0	0	0



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